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Title 26
Internal Revenue

Part 1 (§§ 1.170 to 1.300)

Revised as of April 1, 2025

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Title 1 through Title 16..as of January 1
Title 17 through Title 27 ....as of April 1
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An index to the text of ‘‘Title 3—The President’’ is carried within that volume.

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OLIVER A. POTTS,
Director,
Office of the Federal Register
April 1, 2025

THIS TITLE

Title 26—INTERNAL REVENUE is composed of twenty-two volumes. The contents of these volumes represent all current regulations codified under this title by the Internal Revenue Service, Department of the Treasury, as of April 1, 2025. The first fifteen volumes comprise part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§1.0–1.60; §§1.61–1.139; §§1.140–1.169; §§1.170–1.300; §§1.301–1.400; §§1.401–1.409; §§1.410–1.440; §§1.441–1.500; §§1.501–1.640; §§1.641–1.850; §§1.851–1.907; §§1.908–1.1000; §§1.1001–1.1400; §§1.1401–1.1550; and §1.1551 to end of part 1. The sixteenth volume containing parts 2–29, includes the remainder of subchapter A and all of Subchapter B—Estate and Gift Taxes. The last six volumes contain parts 30–39 (Subchapter C—Employment Taxes and Collection of Income Tax at Source); parts 40–49; parts 50–299 (Subchapter D—Miscellaneous Excise Taxes); parts 300–499 (Subchapter F—Procedure and Administration); parts 500–599 (Subchapter G—Regulations under Tax Conventions); and part 600 to end (Subchapter H—Internal Revenue Practice).

The OMB control numbers for title 26 appear in §602.101 of this chapter. For the convenience of the user, §602.101 appears in the Finding Aids section of the volumes containing parts 1 to 599.

For this volume, Michele Bugenhagen was Chief Editor. The Code of Federal Regulations publication program is under the direction of John Hyrum Martinez, assisted by Stephen J. Frattini.

Title 26—Internal Revenue

(This book contains part 1, §§ 1.170 to 1.300)

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AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.

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Section 1.170A–6 also issued under 26 U.S.C. 170(f)(4); 26 U.S.C. 642(c)(5).

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Section 1.280G–1 also issued under 26 U.S.C. 280G(b) and (e).

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, T.D. 9381, 73 FR 8604, Feb. 15, 2008, unless otherwise noted.

COMPUTATION OF TAXABLE INCOME (CONTINUED)

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS (CONTINUED)

§ 1.170–3 Contributions or gifts by corporations (before amendment by Tax Reform Act of 1969).

(a) *In general.* The deduction by a corporation in any taxable year for charitable contributions, as defined in section 170(c), is limited to 5 percent of its taxable income for the year computed without regard to:

(1) The deduction for charitable contributions,

(2) The special deductions for corporations allowed under part VIII (except section 248), subchapter B, chapter 1 of the Code,

(3) Any net operating loss carryback to the taxable year under section 172,

(4) The special deduction for Western Hemisphere trade corporations under section 922, and

(5) Any capital loss carryback to the taxable year under section 1212(a)(1).

A contribution by a corporation to a trust, chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals is deductible only if the contribution is to be used in the United States or its possessions for those purposes. See section 170(c)(2). For the purposes of section 170, amounts excluded from the gross income of a corporation under section 114 (relating to sports programs conducted for the American National Red Cross) are not to be considered contributions or gifts. For reduction or disallowance of certain charitable, etc., deductions, see paragraphs (c)(2), (e), and (f) of § 1.170–1.

(b) *Election by corporations on an accrual method.* A corporation reporting its taxable income on an accrual method may elect to have a charitable contribution (as defined in section 170 (c)) considered as paid during the taxable year, if payment is actually made on or before the fifteenth day of the third month following the close of the year and if, during the year, the board of directors authorized the contribution. The election must be made at the time the return for the taxable year is filed, by reporting the contribution on the return. There shall be attached to the return when filed a written declaration that the resolution authorizing the contribution was adopted by the board of directors during the taxable year, and the declaration shall be verified by a statement signed by an officer authorized to sign the return that it is made under the penalties of perjury. There shall also be attached to the return when filed a copy of the resolution of the board of directors authorizing the contribution.

(c) *Charitable contributions carryover of corporations*—(1) *Contributions made in taxable years beginning before January 1, 1962.* Subject to the rules set forth in subparagraph (3) of this paragraph, any contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the contribution year) subject to the Code beginning before January 1, 1962, in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the two succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for the succeeding year under the 5-percent limitation of section 170(b)(2) over the contributions made in that year; and

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess contributions; and, in the case of the second taxable year succeeding the contribution year, the portion of the excess contributions not deductible in the first succeeding taxable year.

The application of the rules in this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $10,000 in June 1961, anticipating taxable income for 1961 of $200,000. Its actual taxable income (without regard to any deduction for charitable contributions) for 1961 is only $50,000 and the charitable deduction for that year is limited to $2,500 (5 percent of $50,000). The excess charitable contribution not deductible in 1961 ($7,500) represents a carryover potentially available as a deduction in the two succeeding taxable years. The corporation has taxable income (without regard to any deduction for charitable contributions) of $150,000 in 1962 and makes a charitable contribution of $2,500 in that year. For 1962, the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists first of the $2,500 contribution made in 1962, and $5,000 of the $7,500 carried over from 1961. The remaining $2,500 carried over from 1961 and not allowable as a deduction in 1962 because of the 5-percent limitation may be carried over to 1963. The corporation has taxable income (without regard to any deduction for charitable contributions) of $100,000 in 1963 and makes a charitable contribution of $3,000. For 1963, the corporation may deduct under section 170 the amount of $5,000 (5 percent of $100,000). This amount consists first of the $3,000 contributed in 1963, and $2,000 of the $2,500 carried over from 1961 to 1963. The remaining $500 of the carryover from 1961 is not allowable as a deduction in any year because of the 2-year limitation with respect to excess contributions made in taxable years beginning before January 1, 1962.

(2) *Contributions made in taxable years beginning after December 31, 1961.* Subject to the rules set forth in subparagraph (3) of this paragraph, any contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the contribution year) beginning after December 31, 1961, in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the five succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for such succeeding taxable year under the 5-percent limitation of section 170(b)(2) over the sum of the contributions made in that year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this paragraph in such succeeding taxable year; or

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess contributions, and in the case of the second, third, fourth, or fifth taxable years succeeding the contribution year, the portion of the excess contributions not deductible under this subparagraph for any taxable year intervening between the contribution year and such succeeding taxable year.

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

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $20,000 in June 1964, anticipating taxable income for 1964 of $400,000. Its actual taxable income (without regard to any deduction for charitable contributions) for 1964 is only $100,000 and the charitable deduction for that year is limited to $5,000 (5 percent of $100,000). The excess charitable contribution not deductible in 1964 ($15,000) represents a carryover potentially available as a deduction in the five succeeding taxable years. The corporation has taxable income (without regard to any deduction for charitable contributions) of $150,000 in 1965 and makes a charitable contribution of $5,000 in that year. For 1965 the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists first of the $5,000 contribution made in 1965, and $2,500 carried over from 1964. The remaining $12,500 carried over from 1964 and not allowable as a deduction for 1965 because of the 5-percent limitation may be carried over to 1966. The corporation has taxable income (without regard to any deduction for charitable contributions) of $200,000 in 1966 and makes a charitable contribution of $5,000. For 1966, the corporation may deduct the amount of $10,000 (5 percent of $200,000). This amount consists first of the $5,000 contributed in 1966, and $5,000 of the $12,500 carried over from 1964 to 1966. The remaining $7,500 of the carryover from 1964 is available for purposes of computing the charitable contributions carryover from 1964 to 1967, 1968, and 1969.

(3) *Reduction of excess contributions.* A corporation having a net operating loss carryover (or carryovers) must apply the special rule of section 170(b)(3) and this subparagraph before computing under subparagraph (1) or (2) of this paragraph the charitable contributions carryover for any taxable year subject to the Internal Revenue Code of 1954. In determining the amount of charitable contributions that may be deducted in accordance with the rules set forth in subparagraph (1) or (2) of this paragraph in taxable years succeeding the contribution year, the excess of contributions made by a corporation in the contribution year over the amount deductible in such year must be reduced by the amount by which such excess reduces taxable income (for purposes of determining the net operating loss carryover under the second sentence of section 172(b)(2) and increases a net operating loss carryover to a succeeding taxable year. Thus, if the excess of the contributions made in a taxable year over the amount deductible in the taxable year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding year or years, no charitable contributions carryover will be allowed. If only a portion of the excess charitable contributions is so used, the charitable contributions carryover. will be reduced only to that extent. The application of the rules of this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $10,000 during the taxable year 1960. Its taxable income for 1960 is $80,000 (computed without regard to any net operating loss deduction and computed in accordance with section 170(b)(2) without regard to any deduction for charitable contributions). The corporation has a net operating loss carryover from 1959 of $80,000. In the absence of the net operating loss deduction the corporation would have been allowed a deduction for charitable contributions of $4,000 (5 percent of $80,000). After the application of the net operating loss deduction the corporation is allowed no deduction for charitable contributions, and there is a tentative charitable contribution carryover of $10,000. For purposes of determining the net operating loss carryover to 1961 the corporation computes its taxable income for its prior taxable year 1960 under section 172(b)(2) by deducting the $4,000 charitable contribution. Thus, after the $80,000 net operating loss carryover is applied against the $76,000 of taxable income for 1960 (computed in accordance with section 172(b)(2)), there remains a $4,000 net operating loss carryover to 1961. Since the application of the net operating loss carryover of $80,000 from 1959 reduces the taxable income for 1960 to zero, no part of the $10,000 of charitable contributions in that year is deductible under section 170(b)(2). However, in determining the amount of the allowable charitable contributions carryover to the taxable years 1961 and 1962, the $10,000 must be reduced by the portion thereof ($4,000) which was used to reduce taxable income for 1960 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover to 1961 from zero to $4,000.

(4) *Year contribution is made.* For purposes of this paragraph, contributions made by a corporation in a contribution year include contributions which, in accordance with the provisions of section 170(a)(2) and paragraph (b) of this section, are considered as paid during such contribution year.

(5) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year (computed as provided in this paragraph) shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of contributions shall be

limited to the maximum amount deductible under the 5-percent limitation of section 170(b)(2) (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the contribution year.

(6) *Effect of net operating loss carryback to taxable years succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is deductible (as provided in this paragraph) in a current taxable year (hereinafter referred to in this subparagraph as the ''deduction year'') shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining (under the provisions of section 172(b)(2)) the amount of the net operating loss for any year subsequent to the deduction year which is a carryback or a carryover to taxable years succeeding the deduction year, the amount of contributions shall be limited to the maximum amount deductible under the 5-percent limitation of section 170(b)(2) (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the deduction year.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8096, Aug. 15, 1962; T.D. 6900, 31 FR 14640, Nov. 17, 1966; T.D. 7207, 37 FR 20768, Oct. 4, 1972]

§ 1.170A–1 Charitable, etc., contributions and gifts; allowance of deduction.

(a) *Allowance of deduction.* Any charitable contribution, as defined in section 170(c), actually paid during the taxable year is allowable as a deduction in computing taxable income irrespective of the method of accounting employed or of the date on which the contribution is pledged. However, charitable contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year as provided in section 170(a)(2) and § 1.170A–11. For rules relating to record keeping and return requirements in support of deductions for charitable contributions (whether by an itemizing or nonitemizing taxpayer), see §§ 1.170A–13 (generally applicable to contributions on or before July 30, 2018), 1.170A–14, 1.170A–15, 1.170A–16, 1.170A–17, and 1.170A–18. The deduction is subject to the limitations of section 170(b) and § 1.170A–8 or § 1.170A–11. Subject to the provisions of section 170(d) and §§ 1.170A–10 and 1.170A–11, certain excess charitable contributions made by individuals and corporations shall be treated as paid in certain succeeding taxable years. For provisions relating to direct charitable deductions under section 63 by nonitemizers, see section 63 (b)(1)(C) and (i) and section 170(i). For rules relating to the detemination of, and the deduction for, amounts paid to maintain certain students as members of the taxpayer's household and treated under section 170(g) as paid for the use of an organization described in section 170(c) (2), (3), or (4), see § 1.170A–2. For the reduction of any charitable contributions for interest on certain indebtedness, see section 170(f)(5) and § 1.170A–3. For a special rule relating to the computation of the amount of the deduction with respect to a charitable contribution of certain ordinary income or capital gain property, see section 170(e) and §§ 1.170A–4 and 1.170A–4A. For rules for postponing the time for deduction of a charitable contribution of a future interest in tangible personal property, see section 170(a)(3) and § 1.170A–5. For rules with respect to transfers in trust and of partial interests in property, see section 170(e), section 170(f) (2) and (3), §§ 1.170A–4, 1.170A–6, and 1.170A–7. For definition of the term *section 170(b)(1)(A) organization*, see § 1.170A–9. For valuation of a remainder interest in real property, see section 170(f)(4) and the regulations thereunder. The deduction for charitable contributions is subject to verification by the district director.

(b) *Time of making contribution.* Ordinarily, a contribution is made at the time delivery is effected. The unconditional delivery or mailing of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery or mailing. If a taxpayer unconditionally delivers or mails a properly endorsed stock certificate to a charitable donee or the donee's agent, the gift is completed on the date of delivery or, if such certificate is received in the ordinary course of the mails, on the date of mailing. If the donor delivers the stock certificate to his bank or broker as the donor's agent, or to the issuing corporation or its agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation. For rules relating to the date of payment of a contribution consisting of a future interest in tangible personal property, see section 170(a)(3) and §1.170A–5.

(c) *Value of a contribution in property.* (1) If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) and paragraph (a) of §1.170A–4, or section 170(e)(3) and paragraph (c) of §1.170A–4A.

(2) The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

(3) If a donor makes a charitable contribution of property, such as stock in trade, at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of property contributed would have been sold by the donor at the time of the contribution.

(4) Any costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly reflected in the opening inventory for the year of contribution must be removed from inventory and are not a part of the cost of goods sold for purposes of determining gross income for the year of contribution. Any costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year are to be treated as part of the costs of goods sold for such year. If costs and expenses incurred in producing or acquiring the contributed property are, under the method of accounting used, properly deducted under section 162 or other section of the Code, such costs and expenses will be allowed as deductions for the taxable year in which they are paid or incurred whether or not such year is the year of the contribution. Any such costs and expenses which are treated as part of the cost of goods sold for the year of contribution, and any such costs and expenses which are properly deducted under section 162 or other section of the Code, are not to be treated under any section of the Code as resulting in any basis for the contributed property. Thus, for example, the contributed property has no basis for purposes of determining under section 170(e)(1)(A) and paragraph (a) of §1.170A–4 the amount of gain which would have been recognized if such property had been sold by the donor at its fair market value at the time of its contribution. The amount of any charitable contribution for the taxable year is not to be reduced by the amount of any costs or expenses pertaining to the contributed property which was properly deducted under section 162 or other section of the Code for any taxable year preceding the year of the contribution. This subparagraph applies only to property which was held by the taxpayer for sale in the course of a trade or business. The application of this subparagraph may be illustrated by the following examples:

Example 1. In 1970, A, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. The closing inventory at the end of 1969 properly included $400 of costs attributable to the acquisition of such property, and in 1969 A properly deducted under section 162 $50 of administrative and other expenses attributable to such property. Under section 170(e)(1)(A) and paragraph (a) of §1.170A–4, the amount of the charitable contribution allowed for 1970 is $400 ($600 − [$600 − $400]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $400 which was included in opening inventory for that year.

Example 2. The facts are the same as in *Example 1* except that the contributed property was acquired in 1970 at a cost of $400. The $400 cost of the property is included in determining the cost of goods sold for 1970, and $50 is allowed as a deduction for that year under section 162. A is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of §1.170A–4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example 3. In 1970, B, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of $600. Under §1.471–3(c), the closing inventory at the end of 1969 properly included $450 costs attributable to the production of such property, including $50 of administrative and other indirect expenses which, under his method of accounting, was properly added to inventory rather than deducted as a business expense. Under section 170(e)(1)(A) and paragraph (a) of §1.170A–4, the amount of the charitable contribution allowed for 1970 is $450 ($600 − [$600 − $450]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the $450 which was included in opening inventory for that year.

Example 4. The facts are the same as in *Example 3* except that the contributed property was produced in 1970 at a cost of $450, including $50 of administrative and other indirect expenses. The $450 cost of the property is included in determining the cost of goods sold for 1970. B is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of §1.170A–4 the amount of the charitable contribution is reduced to zero ($600 − [$600 − $0]).

Example 5. In 1970, C, a farmer using the cash method of accounting and the calendar year as the taxable year, contributed to a church a quantity of grain which he had raised having a fair market value of $600. In 1969, C paid expenses of $450 in raising the property which he properly deducted for such year under section 162. Under section 170(e)(1)(A) and paragraph (a) of §1.170A–4, the amount of the charitable contribution in 1970 is reduced to zero ($600 − [$600 − $0]). Accordingly, C is not allowed any deduction under section 170 for the contributed property.

Example 6. The facts are the same as in *Example 5* except that the $450 expenses incurred in raising the contributed property were paid in 1970. The result is the same as in *Example 5,* except the amount of $450 is deductible under section 162 for 1970.

(5) For payments or transfers to an entity described in section 170(c) by a taxpayer carrying on a trade or business, see §1.162–15(a).

(d) *Purchase of an annuity.* (1) In the case of an annuity or portion thereof purchased from an organization described in section 170(c), there shall be allowed as a deduction the excess of the amount paid over the value at the time of purchase of the annuity or portion purchased.

(2) The value of the annuity or portion is the value of the annuity determined in accordance with paragraph (e)(1)(iii) (*b*)(*2*) of §1.101–2.

(3) For determining gain on any such transaction constituting a bargain sale, see section 1011(b) and §1.1011–2.

(e) *Transfers subject to a condition or power.* If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, A is entitled to a deduction under section 170 for his charitable contribution.

(f) *Special rules applicable to certain contributions.* (1) See section 14 of the

Wild and Scenic Rivers Act (Pub. L. 90–542, 82 Stat. 918) for provisions relating to the claim and allowance of the value of certain easements as a charitable contribution under section 170.

(2) For treatment of gifts accepted by the Secretary of State or the Secretary of Commerce, for the purpose of organizing and holding an international conference to negotiate a Patent Corporation Treaty, as gifts to or for the use of the United States, see section 3 of joint resolution of December 24, 1969 (Pub. L. 91–160, 83 Stat. 443).

(3) For treatment of gifts accepted by the Secretary of the Department of Housing and Urban Development, for the purpose of aiding or facilitating the work of the Department, as gifts to or for the use of the United States, see section 7(k) of the Department of Housing and Urban Development Act (42 U.S.C. 3535), as added by section 905 of Pub. L. 91–609 (84 Stat. 1809).

(g) *Contributions of services.* No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible. For the purposes of this paragraph, the phrase *while away from home* has the same meaning as that phrase is used for purposes of section 162 and the regulations thereunder.

(h) *Payment in exchange for consideration*—(1) *Burden on taxpayer to show that all or part of payment is a charitable contribution or gift.* No part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for (as defined in paragraph (h)(4)(i) of this section goods or services (as defined in paragraph (h)(4)(ii) of this section is a contribution or gift within the meaning of section 170(c) unless the taxpayer—

(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and

(ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.

(2) *Limitation on amount deductible*—(i) *In general.* The charitable contribution deduction under section 170(a) for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of—

(A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over

(B) The fair market value of the goods or services received or expected to be received in return.

(ii) *Special rules.* For special limits on the deduction for charitable contributions of ordinary income and capital gain property, see section 170(e) and §§ 1.170A–4 and 1.170A–4A.

(3) *Payments resulting in state or local tax benefits*—(i) *State or local tax credits.* Except as provided in paragraph (h)(3)(vi) of this section, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), the amount of the taxpayer's charitable contribution deduction under section 170(a) is reduced by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer.

(ii) *State or local tax deductions*—(A) *In general.* If a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c), and the taxpayer receives or expects to receive state or local tax deductions that do not exceed the amount of the taxpayer's payment or the fair market value of the property transferred by the taxpayer to the entity, the taxpayer is not required to reduce its charitable contribution deduction under section 170(a) on account of the state or local tax deductions.

(B) *Excess state or local tax deductions.* If the taxpayer receives or expects to receive a state or local tax deduction that exceeds the amount of the taxpayer's payment or the fair market value of the property transferred, the taxpayer's charitable contribution deduction under section 170(a) is reduced.

(iii) *In consideration for*. For purposes of paragraph (h) of this section, the term *in consideration for* has the meaning set forth in paragraph (h)(4)(i) of this section.

(iv) *Amount of reduction*. For purposes of paragraph (h)(3)(i) of this section, the amount of any state or local tax credit is the maximum credit allowable that corresponds to the amount of the taxpayer's payment or transfer to the entity described in section 170(c).

(v) *State or local tax*. For purposes of paragraph (h)(3) of this section, the term *state or local tax* means a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia.

(vi) *Exception*. Paragraph (h)(3)(i) of this section shall not apply to any payment or transfer of property if the total amount of the state and local tax credits received or expected to be received by the taxpayer is 15 percent or less of the taxpayer's payment, or 15 percent or less of the fair market value of the property transferred by the taxpayer.

(vii) *Examples*. The following examples illustrate the provisions of this paragraph (h)(3). The examples in paragraph (h)(6) of this section are not illustrative for purposes of this paragraph (h)(3).

(A) *Example 1. A*, an individual, makes a payment of $1,000 to X, an entity described in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70 percent of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by $700 ($0.70 \times$ $1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the $1,000 payment to X may not exceed $300.

(B)*Example 2. B*, an individual, transfers a painting to Y, an entity described in section 170(c). At the time of the transfer, the painting has a fair market value of $100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10 percent of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15 percent of the fair market value of the property transferred to Y. Accordingly, the amount of B's charitable contribution deduction for the transfer of the painting is not reduced under paragraph (h)(3)(i) of this section.

(C) *Example 3. C*, an individual, makes a payment of $1,000 to Z, an entity described in section 170(c). In exchange for the payment, under state M law, C is entitled to receive a state tax deduction equal to the amount paid by C to Z. Under paragraph (h)(3)(ii)(A) of this section, C's charitable contribution deduction under section 170(a) is not required to be reduced on account of C's state tax deduction for C's payment to Z.

(viii) *Safe harbor for payments by C corporations and specified passthrough entities*. For payments by a C corporation or by a specified passthrough entity to an entity described in section 170(c), where the C corporation or specified passthrough entity receives or expects to receive a State or local tax credit that reduces the charitable contribution deduction for such payments under paragraph (h)(3) of this section, see § 1.162–15(a)(3) (providing safe harbors under section 162(a) to the extent of that reduction).

(ix) *Safe harbor for individuals*. Under certain circumstances, an individual who itemizes deductions and makes a payment to an entity described in section 170(c) in consideration for a State or local tax credit may treat the portion of such payment for which a charitable contribution deduction is disallowed under paragraph (h)(3) of this section as a payment of State or local taxes under section 164. See § 1.164–3(j), providing a safe harbor for certain payments by individuals in exchange for State or local tax credits.

(x) *Effective/applicability date*. This paragraph (h)(3) applies to amounts paid or property transferred by a taxpayer after August 27, 2018.

(4) *Definitions.* For purposes of this paragraph (h), the following definitions apply:

(i) *In consideration for.* A taxpayer receives goods or services in consideration for a taxpayer's payment or transfer to an entity described in section 170(c) if, at the time the taxpayer makes the payment to such entity, the taxpayer receives or expects to receive goods or services from that entity or any other party in return.

(ii) *Goods or services.* Goods or services means cash, property, services, benefits, and privileges.

(iii) *Applicability date.* The definitions provided in this paragraph (h)(4) are applicable to amounts paid or property transferred on or after December 17, 2019.

(5) *Certain goods or services disregarded.* For purposes of section 170(a) and paragraphs (h)(1) and (h)(2) of this section, goods or services described in §1.170A–13(f)(8)(i) or §1.170A–13(f)(9)(i) are disregarded.

(6) *Donee estimates of the value of goods or services may be treated as fair market value*—(i) *In general.* For purposes of section 170(a), a taxpayer may rely on either a contemporaneous written acknowledgment provided under section 170(f)(8) and §1.170A–13(f) or a written disclosure statement provided under section 6115 for the fair market value of any goods or services provided to the taxpayer by the donee organization.

(ii) *Exception.* A taxpayer may not treat an estimate of the value of goods or services as their fair market value if the taxpayer knows, or has reason to know, that such treatment is unreasonable. For example, if a taxpayer knows, or has reason to know, that there is an error in an estimate provided by an organization described in section 170(c) pertaining to goods or services that have a readily ascertainable value, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services. Similarly, if a taxpayer is a dealer in the type of goods or services provided in consideration for the taxpayer's payment and knows, or has reason to know, that the estimate is in error, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services.

(7) *Examples.* The following examples illustrate the rules of this paragraph (h).

Example 1. Certain goods or services disregarded. Taxpayer makes a $50 payment to Charity *B*, an organization described in section 170(c), in exchange for a family membership. The family membership entitles Taxpayer and members of Taxpayer's family to certain benefits. These benefits include free admission to weekly poetry readings, discounts on merchandise sold by *B* in its gift shop or by mail order, and invitations to special events for members only, such as lectures or informal receptions. When *B* first offers its membership package for the year, *B* reasonably projects that each special event for members will have a cost to *B*, excluding any allocable overhead, of $5 or less per person attending the event. Because the family membership benefits are disregarded pursuant to §1.170A–13(f)(8)(i), Taxpayer may treat the $50 payment as a contribution or gift within the meaning of section 170(c), regardless of Taxpayer's intent and whether or not the payment exceeds the fair market value of the goods or services. Furthermore, any charitable contribution deduction available to Taxpayer may be calculated without regard to the membership benefits.

Example 2. Treatment of good faith estimate at auction as the fair market value. Taxpayer attends an auction held by Charity *C*, an organization described in section 170(c). Prior to the auction, *C* publishes a catalog that meets the requirements for a written disclosure statement under section 6115(a) (including *C*'s good faith estimate of the value of items that will be available for bidding). A representative of *C* gives a copy of the catalog to each individual (including Taxpayer) who attends the auction. Taxpayer notes that in the catalog *C*'s estimate of the value of a vase is $100. Taxpayer has no reason to doubt the accuracy of this estimate. Taxpayer successfully bids and pays $500 for the vase. Because Taxpayer knew, prior to making her payment, that the estimate in the catalog was less than the amount of her payment, Taxpayer satisfies the requirement of paragraph (h)(1)(i) of this section. Because Taxpayer makes a payment in an amount that exceeds that estimate, Taxpayer satisfies the requirements of paragraph (h)(1)(ii) of this section. Taxpayer may treat *C*'s estimate of the value of the vase as its fair market value in determining the amount of her charitable contribution deduction.

Example 3. Good faith estimate not in error. Taxpayer makes a $200 payment to Charity *D*, an organization described in section 170(c). In return for Taxpayer's payment, *D* gives Taxpayer a book that Taxpayer could buy at retail prices typically ranging from $18 to $25. *D* provides Taxpayer with a good faith estimate, in a written disclosure statement under section 6115(a), of $20 for the value of the book. Because the estimate is within the range of typical retail prices for the book, the estimate contained in the written disclosure statement is not in error. Although Taxpayer knows that the book is sold for as much as $25, Taxpayer may treat the estimate of $20 as the fair market value of the book in determining the amount of his charitable contribution deduction.

(i) [Reserved]

(j) *Exceptions and other rules.* (1) The provisions of section 170 do not apply to contributions by an estate; nor do they apply to a trust unless the trust is a private foundation which, pursuant to section 642(c)(6) and §1.642(c)–4, is allowed a deduction under section 170 subject to the provisions applicable to individuals.

(2) No deduction shall be allowed under section 170 for a charitable contribution to or for the use of an organization or trust described in section 508(d) or 4948(c)(4), subject to the conditions specified in such sections and the regulations thereunder.

(3) For disallowance of deductions for contributions to or for the use of communist controlled organizations, see section 11(a) of the Internal Security Act of 1950, as amended (50 U.S.C. 790).

(4) For denial of deductions for charitable contributions as trade or business expenses and rules with respect to treatment of payments to organizations other than those described in section 170(c), see section 162 and the regulations thereunder.

(5) No deduction shall be allowed under section 170 for amounts paid to an organization:

(i) Which is disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, or

(ii) Which participates in, or intervenes in (including the publishing or distribution of statements), any political campaign on behalf of or in opposition to any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see sections 501(c)(3), 501(h), 4911 and the regulations thereunder.

(6) No deduction shall be allowed under section 170 for expenditures for lobbying purposes, the promotion or defeat of legislation, etc. See also the regulations under sections 162 and 4945.

(7) No deduction for charitable contributions is allowed in computing the taxable income of a common trust fund or of a partnership. See sections 584(d)(3) and 703(a)(2)(D). However, a partner's distributive share of charitable contributions actually paid by a partnership during its taxable year may be allowed as a deduction in the partner's separate return for his taxable year with or within which the taxable year of the partnership ends, to the extent that the aggregate of his share of the partnership contributions and his own contributions does not exceed the limitations in section 170(b).

(8) For charitable contributions paid by a nonresident alien individual or a foreign corporation, see §1.170A–4(b)(5) and sections 873, 876, 877, and 882(c), and the regulations thereunder.

(9) Charitable contributions paid by bona fide residents of a section 931 possession as defined in §1.931–1(c)(1) or Puerto Rico are deductible only to the extent allocable to income that is not excluded under section 931 or 933. For the rules for allocating deductions for charitable contributions, see the regulations under section 861.

(10) For carryover of excess charitable contributions in certain corporate acquisitions, see section 381(c)(19) and the regulations thereunder.

(11) No deduction shall be allowed under section 170 for out-of-pocket expenditures on behalf of an eligible organization (within the meaning of §1.501(h)–2(b)(1)) if the expenditure is made in connection with influencing legislation (within the meaning of section 501(c)(3) or §56.4911–2), or in connection with the payment of the organization's tax liability under section 4911. For the treatment of similar expenditures on behalf of other organizations see paragraph (h)(6) of this section.

(k) *Effective/applicability date.* In general this section applies to contributions made in taxable years beginning after December 31, 1969. Paragraph (j)(11) of this section, however, applies only to out-of-pocket expenditures made in taxable years beginning after December 31, 1976. In addition, paragraph (h) of this section applies only to payments made on or after December 16, 1996. However, taxpayers may rely on the rules of paragraph (h) of this section for payments made on or after January 1, 1994. Paragraph (j)(9) of this section is applicable for taxable years ending after April 9, 2008. The third sentence of paragraph (a) applies as provided in the sections referenced in that sentence.

(68A Stat. 58, 26 U.S.C. 170(a)(1); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7207, 37 FR 20771, Oct. 4, 1972, as amended by T.D. 7340, 40 FR 1238, Jan. 7, 1975; T.D. 7807, 47 FR 4510, Feb. 1, 1982; T.D. 8002, 49 FR 50666, Dec. 31, 1984; T.D. 8308, 55 FR 35587, Aug. 31, 1990; T.D. 8690, 61 FR 65951, Dec. 16, 1996; T.D. 9194, 70 FR 18928, Apr. 11, 2005; T.D. 9391, 73 FR 19358, Apr. 9, 2008; T.D. 9836, 83 FR 36421, July 30, 2018; 83 FR 45827, Sept. 11, 2018; T.D. 9864, 84 FR 27530, June 13, 2019; T.D, 9907, 85 FR 48474, Aug. 11, 2020]

§ 1.170A–2 Amounts paid to maintain certain students as members of the taxpayer's household.

(a) *In general.* (1) The term *charitable contributions* includes amounts paid by the taxpayer during the taxable year to maintain certain students as members of his household which, under the provisions of section 170(h) and this section, are treated as amounts paid for the use of an organization described in section 170(c) (2), (3), or (4), and such amounts, to the extent they do not exceed the limitations under section 170(h)(2) and paragraph (b) of this section, are contributions deductible under section 170. In order for such amounts to be so treated, the student must be an individual who is neither a dependent (as defined in section 152) of the taxpayer nor related to the taxpayer in a manner described in any of the paragraphs (1) through (8) of section 152(a), and such individual must be a member of the taxpayer's household pursuant to a written agreement between the taxpayer and an organization described in section 170(c) (2), (3), or (4) to implement a program of the organization to provide educational opportunities for pupils or students placed in private homes by such organization. Furthermore, such amounts must be paid to maintain such individual during the period in the taxable year he is a member of the taxpayer's household and is a full-time pupil or student in the 12th or any lower grade at an educational institution, as defined in section 151(e)(4) and § 1.151–3, located in the United States. Amounts paid outside of such period, but within the taxable year, for expenses necessary for the maintenance of the student during the period will qualify for the charitable contributions deduction if the other limitation requirements of the section are met.

(2) For purposes of subparagraph (1) of this paragraph, amounts treated as charitable contributions include only those amounts actually paid by the taxpayer during the taxable year which are directly attributable to the maintenance of the student while he is a member of the taxpayer's household and is attending an educational institution on a full-time basis. This would include amounts paid to insure the well-being of the individual and to carry out the purpose for which the individual was placed in the taxpayer's home. For example, a deduction under section 170 would be allowed for amounts paid for books, tuition, food, clothing, transportation, medical and dental care, and recreation for the individual. Amounts treated as charitable contributions under this section do not include amounts which the taxpayer would have expended had the student not been in the household. They would not include, for example, amounts paid in connection with the taxpayer's home for taxes, insurance, interest on a mortgage, repairs, etc. Moreover, such amounts do not include any depreciation sustained by the taxpayer in maintaining such student or students in his household, nor do they include the value of any services rendered on behalf of such student or students by the taxpayer or any member of the taxpayer's household.

(3) For purposes of section 170(h) and this section, an individual will be considered to be a full-time pupil or student at an educational institution only if he is enrolled for a course of study prescribed for a full-time student at such institution and is attending classes on a full-time basis. Nevertheless,

such individual may be absent from school due to special circumstances and still be considered to be in full-time attendance. Periods during the regular school term when the school is closed for holidays, such as Christmas and Easter, and for periods between semesters are treated as periods during which the pupil or student is in full-time attendance at the school. Also, absences during the regular school term due to illness of such individual shall not prevent him from being considered as a full-time pupil or student. Similarly, absences from the taxpayer's household due to special circumstances will not disqualify the student as a member of the household. Summer vacations between regular school terms are not considered periods of school attendance.

(4) When claiming a deduction for amounts described in section 170(h) and this section, the taxpayer must submit with his return a copy of his agreement with the organization sponsoring the individual placed in the taxpayer's household, together with a summary of the various items for which amounts were paid to maintain such individual, and a statement as to the date the individual became a member of the household and the period of his full-time attendance at school and the name and location of such school. Substantiation of amounts claimed must be supported by adequate records of the amounts actually paid. Due to the nature of certain items, such as food, a record of amount spent for all members of the household, with an equal portion thereof allocated to each member, will be acceptable.

(b) *Limitations.* Section 170(h) and this section shall apply to amounts paid during the taxable year only to the extent that the amounts paid in maintaining each pupil or student do not exceed $50 multiplied by the number of full calendar months in the taxable year that the pupil or student is maintained in accordance with the provisions of this section. For purposes of such limitation if 15 or more days of a calendar month fall within the period to which the maintenance of such pupil or student relates, such month is considered as a full calendar month. To the extent that such amounts qualify as charitable contributions under section 170(c), the aggregate of such amounts plus other contributions made during the taxable year for the use of an organization described in section 170(c) is deductible under section 170 subject to the limitation provided in section 170(b)(1)(B) and paragraph (c) of §1.170A–8.

(c) *Compensation or reimbursement.* Amounts paid during the taxable year to maintain a pupil or student as a member of the taxpayer's household as provided in paragraph (a) of this section, shall not be taken into account under section 170(h) and this section, if the taxpayer receives any money or other property as compensation or reimbursement for any portion of such amounts. The taxpayer will not be denied the benefits of section 170(h) if he prepays an extraordinary or nonrecurring expense such as a hospital bill or vacation trip, at the request of the individual's parents or the sponsoring organization and is reimbursed for such prepayment. The value of services performed by the pupil or student in attending to ordinary chores of the household will generally not be considered to constitute compensation or reimbursement. However, if the pupil or student is taken into the taxpayer's household to replace a former employee of the taxpayer or gratuitously to perform substantial services for the taxpayer, the facts and circumstances may warrant a conclusion that the taxpayer received reimbursement for maintaining the pupil or student.

(d) *No other amount allowed as deduction.* Except to the extent that amounts described in section 170(h) and this section are treated as charitable contributions under section 170(c) and, therefore, deductible under section 170(a), no deduction is allowed for any amount paid to maintain an individual, as a member of the taxpayer's household, in accordance with the provisions of section 170(h) and this section.

(e) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. The X organization is an organization described in section 170(c)(2) and is engaged in a program under which a number of European children are placed in the homes of

U.S. residents in order to further the children's high school education. In accordance with paragraph (a) of this section, the taxpayer, A, who reports his income on the calendar year basis, agreed with X to take two of the children, and they were placed in the taxpayer's home on January 2, 1970, where they remained until January 21, 1971, during which time they were fully maintained by the taxpayer. The children enrolled at the local high school for the full course of study prescribed for 10th grade students and attended the school on a full-time basis for the spring semester starting January 18, 1970, and ending June 3, 1970, and for the fall semester starting September 1, 1970, and ending January 13, 1971. The total cost of food paid by A in 1970 for himself, his wife, and the two children amounted to $1,920, or $40 per month for each member of the household. Since the children were actually full-time students for only 8½ months during 1970, the amount paid for food for each child during that period amounted to $340. Other amounts paid during the 8 1/2-month period for each child for laundry, lights, water, recreation, and school supplies amounted to $160. Thus, the amounts treated under section 170(h) and this section as paid for the use of X would, with respect to each child, total $500 ($340 + $160), or a total for both children of $1,000, subject to the limitations of paragraph (b) of this section. Since, for purposes of such limitations, the children were full-time students for only 8 full calendar months during 1970 (less than 15 days in January 1970), the taxpayer may treat only $800 as a charitable contribution made in 1970, that is, $50 multiplied by the 8 full calendar months, or $400 paid for the maintenance of each child. Neither the excess payments nor amounts paid to maintain the children during the period before school opened and for the period in summer between regular school terms is taken into account by reason of section 170(h). Also, because the children were full-time students for less than 15 days in January 1971 (although maintained in the taxpayer's household for 21 days), amounts paid to maintain the children during 1971 would not qualify as a charitable contribution.

Example 2. A religious organization described in section 170(c)(2) has a program for providing educational opportunities for children it places in private homes. In order to implement the program, the taxpayer, H, who resides with his wife, son, and daughter of high school age in a town in the United States, signs an agreement with the organization to maintain a girl sponsored by the organization as a member of his household while the child attends the local high school for the regular 1970–71 school year. The child is a full-time student at the school during the school year starting September 6, 1970, and ending June 6, 1971, and is a member of the taxpayer's household during that period. Although the taxpayer pays $200 during the school period falling in 1970, and $240 during the school period falling in 1971, to maintain the child, he cannot claim either amount as a charitable contribution because the child's parents, from time to time during the school year, send butter, eggs, meat, and vegetables to H to help defray the expenses of maintaining the child. This is considered property received as reimbursement under paragraph (c) of this section. Had her parents not contributed the food, the fact that the child, in addition to the normal chores she shared with the taxpayer's daughter, such as cleaning their own rooms and helping with the shopping and cooking, was responsible for the family laundry and for the heavy cleaning of the entire house while the taxpayer's daughter had no comparable responsibilities would also preclude a claim for a charitable contributions deduction. These substantial gratuitous services are considered property received as reimbursement under paragraph (c) of this section.

Example 3. A taxpayer resides with his wife in a city in the eastern United States. He agrees, in writing, with a fraternal society described in section 170(c)(4) to accept a child selected by the society for maintenance by him as a member of his household during 1971 in order that the child may attend the local grammar school as a part of the society's program to provide elementary education for certain children selected by it. The taxpayer maintains the child, who has as his principal place of abode the home of the taxpayer, and is a member of the taxpayer's household, during the entire year 1971. The child is a full-time student at the local grammar school for 9 full calendar months during the year. Under the agreement, the society pays the taxpayer $30 per month to help maintain the child. Since the $30 per month is considered as compensation or reimbursement to the taxpayer for some portion of the maintenance paid on behalf of the child, no amounts paid with respect to such maintenance can be treated as amounts paid in accordance with section 170(h). In the absence of the $30 per month payments, if the child qualifies as a dependent of the taxpayer under section 152(a)(9), that fact would also prevent the maintenance payments from being treated as charitable contributions paid for the use of the fraternal society.

(f) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20774, Oct. 4, 1972]

§ 1.170A–3 Reduction of charitable contribution for interest on certain indebtedness.

(a) *In general.* Section 170(f)(5) requires that the amount of a charitable contribution be reduced for certain interest to the extent necessary to avoid the deduction of the same amount both as an interest deduction under section 163 and as a deduction for charitable contributions under section 170. The reduction is to be determined in accordance with paragraphs (b) and (c) of this section.

(b) *Interest attributable to postcontribution period.* In determining the amount to be taken into account as a charitable contribution for purposes of section 170, the amount determined without regard to section 170(f)(5) or this section shall be reduced by the amount of interest which has been paid, or is to be paid, by the taxpayer, which is attributable to any liability connected with the contribution, and which is attributable to any period of time after the making of the contribution. The deduction otherwise allowable for charitable contributions under section 170 is required to be reduced pursuant to section 170(f)(5) and this section only if, in connection with a charitable contribution, a liability is assumed by the recipient of the contribution or by any other person or if the charitable contribution is of property which is subject to a liability. Thus, if a charitable contribution is made in property and the transfer is conditioned upon the assumption of a liability by the donee or by some other person, the contribution must be reduced by the amount of any interest which has been paid, or will be paid, by the taxpayer, which is attributable to the liability, and which is attributable to any period after the making of the contribution. The adjustment referred to in this paragraph must also be made where the contributed property is subject to a liability and the value of the property reflects the payment by the donor of interest with respect to a period of time after the making of the contribution.

(c) *Interest attributable to precontribution period.* If, in connection with the charitable contribution of a bond, a liability is assumed by the recipient or by any other person, or if the bond is subject to a liability, then, in determining the amount to be taken into account as a charitable contribution under section 170, the amount determined without regard to section 170(f)(5) and this section shall, without regard to whether any reduction may be required by paragraph (b) of this section, also be reduced for interest which has been paid, or is to be paid, by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and which is attributable to any period before the making of the contribution. However, the reduction referred to in this paragraph shall be made only to the extent that such reduction does not exceed the interest (including bond discount and other interest equivalent) receivable on the bond, and attributable to any period before the making of the contribution which is not, by reason of the taxpayer's method of accounting, includible in the taxpayer's gross income for any taxable year. For purposes of section 170(f)(5) and this section the term *bond* means any bond, debenture, note, or certificate or other evidence of indebtedness.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. On January 1, 1970, A, a cash basis taxpayer using the calendar year as the taxable year, contributed to a charitable organization real estate having a fair market value and adjusted basis of $10,000. In connection with the contribution the charitable organization assumed an indebtedness of $8,000 which A had incurred. On December 31, 1969, A prepaid one year's interest on that indebtedness for 1970, amounting to $960, and took an interest deduction of $960 for such amount. The amount of the gift, determined without regard to this section, is $2,960 ($10,000 less $8,000, the outstanding indebtedness, plus $960, the amount of prepaid interest). In determining the amount of the deduction for the charitable contribution, the value of the gift ($2,960) must be reduced by $960 to eliminate from the computation of such deduction that portion thereof for which A has been allowed an interest deduction.

Example 2. (a) On January 1, 1970, B, an individual using the cash receipts and disbursements method of accounting, purchased for $9,950 a 5½ percent $10,000, 20-year M Corporation bond, the interest on which was payable semiannually on June 30 and December 31. The M Corporation had issued the bond on January 1, 1960, at a discount of $720 from the principal amount. On December 1, 1970, B donated the bond to a charitable organization, and, in connection with the contribution, the charitable organization assumed an indebtedness of $7,000 which B had incurred to purchase and carry the bond.

(b) During the calendar year 1970 B paid accrued interest of $330 on the indebtedness for the period from January 1, 1970, to December 1, 1970, and has taken an interest deduction of $330 for such amount. No portion of the bond discount of $36 a year ($720 divided by 20 years) has been included in B's income, and of the $550 of annual interest receivable on the bond, he included in income only the June 30, 1970, payment of $275.

(c) The market value of the bond on December 1, 1970, was $9,902. Such value includes $229 of interest receivable which had accrued from July 1 to December 1, 1970.

(d) The amount of the charitable contribution determined without regard to this section is $2,902 ($9,902, the value of the property on the date of gift, less $7,000, the amount of the liability assumed by the charitable organization). In determining the amount of the allowable deduction for charitable contributions, the value of the gift ($2,902) must be reduced to eliminate from the deduction that portion thereof for which B has been allowed an interest deduction. Although the amount of such interest deduction was $330, the reduction required by this section is limited to $262, since the reduction is not in excess of the amount of interest income on the bond ($229 of accrued interest plus $33, the amount of bond discount attributable to the 11-month period B held the bond).

(e) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20775, Oct. 4, 1972]

§ 1.170A–4 Reduction in amount of charitable contributions of certain appreciated property.

(a) *Amount of reduction.* Section 170(e)(1) requires that the amount of the charitable contribution which would be taken into account under section 170(a) without regard to section 170(e) shall be reduced before applying the percentage limitations under section 170(b):

(1) In the case of a contribution by an individual or by a corporation of ordinary income property, as defined in paragraph (b)(1) of this section, by the amount of gain (hereinafter in this section referred to as ordinary income) which would have been recognized as gain which is not long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization,

(2) In the case of a contribution by an individual of section 170(e) capital gain property, as defined in paragraph (b)(2) of this section, by 50 percent of the amount of gain (hereinafter in this section referred to as long-term capital gain) which would have been recognized as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization, and

(3) In the case of a contribution by a corporation of section 170(e) capital gain property, as defined in paragraph (b)(2) of this section, by 62½ percent of the amount of gain (hereinafter in this section referred to as long-term capital gain) which would have been recognized as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

Section 170(e)(1) and this paragraph do not apply to reduce the amount of the charitable contribution where, by reason of the transfer of the contributed property, ordinary income or capital gain is recognized by the donor in the same taxable year in which the contribution is made. Thus, where income or gain is recognized under section 453(d) upon the transfer of an installment obligation to a charitable organization, or under section 454(b) upon the transfer of an obligation issued at a discount to such an organization, or upon the assignment of income to such an organization, section 170(e)(1) and this paragraph do not apply if recognition of the income or gain occurs in the same taxable year in which the contribution is made. Section 170(e)(1) and this paragraph apply to a charitable contribution of an interest in ordinary income property or section 170(e) capital gain property which is described in paragraph (b) of § 1.170A–6, or paragraph (b) of § 1.170A–7. For purposes of applying section 170(e)(1) and this paragraph it is immaterial whether the charitable contribution is made ''to'' the charitable organization or whether it is made ''for the use of'' the charitable organization. See § 1.170A–8(a)(2).

(b) *Definitions and other rules.* For purposes of this section:

(1) *Ordinary income property.* The term *ordinary income property* means property any portion of the gain on which would not have been long term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization. Such term includes, for example, property held by the donor primarily for sale to customers in the ordinary course of his trade or business, a work of art created by the donor, a manuscript prepared by the donor, letters and memorandums prepared by or for the donor, a capital asset held by the donor for not more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977), and stock described in section 306(a), 341(a), or 1248(a) to the extent that, after applying such section, gain on its disposition would not have been long-term capital gain. The term does not include an income interest in respect of which a deduction is allowed under section 170(f)(2)(B) and paragraph (c) of § 1.170A–6.

(2) *Section 170(e) capital gain property.* The term *section 170(e) capital gain property* means property any portion of the gain on which would have been treated as long-term capital gain if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization and which:

(i) Is contributed to or for the use of a private foundation, as defined in section 509(a) and the regulations thereunder, other than a private foundation described in section 170(b)(1)(E),

(ii) Constitutes tangible personal property contributed to or for the use of a charitable organization, other than a private foundation to which subdivision (i) of this subparagraph applies, which is put to an unrelated use by the charitable organization within the meaning of subparagraph (3) of this paragraph, or

(iii) Constitutes property not described in subdivision (i) or (ii) of this subparagraph which is 30-percent capital gain property to which an election under paragraph (d)(2) of § 1.170A–8 applies.

For purposes of this subparagraph a fixture which is intended to be severed from real property shall be treated as tangible personal property.

(3) *Unrelated use*—(i) *In general.* The term *unrelated use* means a use which is unrelated to the purpose or function constituting the basis of the charitable organization's exemption under section 501 or, in the case of a contribution of property to a governmental unit, the use of such property by such unit for other than exclusively public purposes. For example, if a painting contributed to an educational institution is used by that organization for educational purposes by being placed in its library for display and study by art students, the use is not an unrelated use; but if the painting is sold and the proceeds used by the organization for educational purposes, the use of the property is an unrelated use. If furnishings contributed to a charitable organization are used by it in its offices and buildings in the course of carrying out its functions, the use of the property is not an unrelated use. If a set or collection of items of tangible personal property is contributed to a charitable organization or governmental unit, the use of the set or collection is not an unrelated use if the donee sells or otherwise disposes of only an insubstantial portion of the set or collection. The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization.

(ii) *Proof of use.* For purposes of applying subparagraph (2)(ii) of this paragraph, a taxpayer who makes a charitable contribution of tangible personal property to or for the use of a charitable organization or governmental unit may treat such property as not being put to an unrelated use by the donee if:

(*a*) He establishes that the property is not in fact put to an unrelated use by the donee, or

(*b*) At the time of the contribution or at the time the contribution is treated as made, it is reasonable to anticipate that the property will not be put to an unrelated use by the donee. In the case of a contribution of tangible personal property to or for the use of a museum, if the object donated is of a general type normally retained by such museum or other museums for museum purposes, it will be reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the object will not be put to an unrelated use by the donee, whether or not the object is later sold or exchanged by the donee.

(4) *Property used in trade or business.* For purposes of applying subparagraphs (1) and (2) of this paragraph, property which is used in the trade or business, as defined in section 1231(b), shall be treated as a capital asset, except that any gain in respect of such property which would have been recognized if the property had been sold by the donor at its fair market value at the time of its contribution to the charitable organization shall be treated as ordinary income to the extent that such gain would have constituted ordinary income by reason of the application of section 617 (d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

(5) *Nonresident alien individuals and foreign corporations.* The reduction in the case of a nonresident alien individual or a foreign corporation shall be determined by taking into account the gain which would have been recognized and subject to tax under chapter 1 of the Code if the property had been sold or disposed of within the United States by the donor at its fair market value at the time of its contribution to the charitable organization. However, the amount of such gain which would have been subject to tax under section 871(a) or 881 (relating to gain not effectively connected with the conduct of a trade or business within the United States) if there had been a sale or other disposition within the United States shall be treated as long-term capital gain. Thus, a charitable contribution by a nonresident alien individual or a foreign corporation of property the sale or other disposition of which within the United States would have resulted in gain subject to tax under section 871(a) or 881 will be reduced only as provided in section 170(e)(1)(B) and paragraph (a) (2) or (3) of this section, but only if the property contributed is described in subdivision (i), (ii), or (iii) of subparagraph (2) of this paragraph. A charitable contribution by a nonresident alien individual or a foreign corporation of property the sale or other disposition of which within the United States would have resulted in gain subject to tax under section 871(a) or 881 will in no case be reduced under section 170(e)(1)(A) and paragraph (a)(1) of this section.

(c) *Allocation of basis and gain*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph:

(i) If a taxpayer makes a charitable contribution of less than his entire interest in appreciated property, whether or not the transfer is made in trust, as, for example, in the case of a transfer of appreciated property to a pooled income fund described in section 642(c)(5) and §1.642(c)–5, and is allowed a deduction under section 170 for a portion of the fair market value of such property, then for purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property the taxpayer's adjusted basis in such property at the time of the contribution shall be allocated under section 170(e)(2) between the contributed portion of the property and the noncontributed portion.

(ii) The adjusted basis of the contributed portion of the property shall be that portion of the adjusted basis of the entire property which bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property.

(iii) The ordinary income and the long-term capital gain which shall be taken into account in applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property shall be the amount of gain which would have been recognized as ordinary income and long-term capital gain if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(2) *Bargain sale.* (i) Section 1011(b) and §1.1011–2 apply to bargain sales of

property to charitable organizations. For purposes of applying the reduction rules of section 170(e)(1) and this section to the contributed portion of the property in the case of a bargain sale, there shall be allocated under section 1011(b) to the contributed portion of the property that portion of the adjusted basis of the entire property that bears the same ratio to the total adjusted basis as the fair market value of the contributed portion of the property bears to the fair market value of the entire property. For purposes of applying section 170(e)(1) and paragraph (a) of this section to the contributed portion of the property in such a case, there shall be allocated to the contributed portion the amount of gain that is not recognized on the bargain sale but that would have been recognized if such contributed portion had been sold by the donor at its fair market value at the time of its contribution to the charitable organization.

(ii) The term *bargain sale*, as used in this subparagraph, means a transfer of property which is in part a sale or exchange of the property and in part a charitable contribution, as defined in section 170(c), of the property.

(3) *Ratio of ordinary income and capital gain.* For purposes of applying subparagraphs (1)(iii) and (2)(i) of this paragraph, the amount of ordinary income (or long-term capital gain) which would have been recognized if the contributed portion of the property had been sold by the donor at its fair market value at the time of its contribution shall be that amount which bears the same ratio to the ordinary income (or long-term capital gain) which would have been recognized if the entire property had been sold by the donor at its fair market value at the time of its contribution as (i) the fair market value of the contributed portion at such time bears to (ii) the fair market value of the entire property at such time. In the case of a bargain sale, the fair market value of the contributed portion for purposes of subdivision (i) is the amount determined by subtracting from the fair market value of the entire property the amount realized on the sale.

(4) *Donee's basis of property acquired.* The adjusted basis of the contributed portion of the property, as determined under subparagraph (1) or (2) of this paragraph, shall be used by the donee in applying to the contributed portion such provisions as section 514(a)(1), relating to adjusted basis of debt-financed property; section 1015(a), relating to basis of property acquired by gift; section 4940(c)(4), relating to capital gains and losses in determination of net investment income; and section 4942(f)(2)(B), relating to net short-term capital gain in determination of tax on failure to distribute income. The fair market value of the contributed portion of the property at the time of the contribution shall not be used by the donee as the basis of such contributed portion.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. (a) On July 1, 1970, C, an individual, makes the following charitable contributions, all of which are made to a church except in the case of the stock (as indicated):

Property	Fair market value	Adjusted basis	Recognized gain sold
Ordinary income property	$50,000	$35,000	$15,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock held more than 6 months contributed to—.			
(i) A church	25,000	21,000	4,000
(ii) A private foundation not described in section 170(b)(1)(E)	15,000	10,000	5,000
(2) Tangible personal property held more than 6 months (put to unrelated use by church)	12,000	6,000	6,000
Total	102,000	72,000	30,000

(b) After making the reductions required by paragraph (a) of this section, the amount of charitable contributions allowed (before application of section 170(b) limitations) is as follows:

Property	Fair market value	Reduction	Contribution allowed
Ordinary income property	$50,000	$15,000	$35,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock contributed to:.			
(i) The church	25,000	....	25,000
(ii) The private foundation	15,000	2,500	12,500

Property	Fair market value	Reduction	Contribution allowed
(2) Tangible personal property	12,000	3,000	9,000
Total	102,000	20,500	81,500

(c) If C were a corporation, rather than an individual, the amount of charitable contributions allowed (before application of section 170(b) limitation) would be as follows:

Property	Fair market value	Reduction	Contribution allowed
Ordinary income property	$50,000	$15,000	$35,000
Property which, if sold, would produce long-term capital gain:			
(1) Stock contributed to:.			
(i) The church	25,000	....	25,000
(ii) The private foundation	15,000	3,125	11,875
(2) Tangible personal property	12,000	3,750	8,250
Total	102,000	21,875	80,125

Example 2. On March 1, 1970, D, an individual, contributes to a church intangible property to which section 1245 applies which has a fair market value of $60,000 and an adjusted basis of $10,000. At the time of the contribution D has used the property in his business for more than 6 months. If the property had been sold by D at its fair market value at the time of its contribution, it is assumed that under section 1245 $20,000 of the gain of $50,000 would have been treated as ordinary income and $30,000 would have been long-term capital gain. Under paragraph (a)(1) of this section, D's contribution of $60,000 is reduced by $20,000.

Example 3. The facts are the same as in *Example 2* except that the property is contributed to a private foundation not described in section 170(b)(1)(E). Under paragraph (a) (1) and (2) of this section, D's contribution is reduced by $35,000 (100 percent of the ordinary income of $20,000 and 50 percent of the long-term capital gain of $30,000).

Example 4. (a) In 1971, E, an individual calendar-year taxpayer, contributes to a church stock held for more than 6 months which has a fair market value of $90,000 and an adjusted basis of $10,000. In 1972, E also contributes to a church stock held for more than 6 months which has a fair market value of $20,000 and an adjusted basis of $10,000. E's contribution base for 1971 is $200,000; and for 1972, is $150,000. E makes no other charitable contributions for these 2 taxable years.

(b) For 1971 the amount of the contribution which may be taken into account under section 170(a) is limited by section 170(b)(1)(D)(i) to $60,000 ($200,000 × 30%), and A is allowed a deduction for $60,000. Under section 170(b)(1)(D)(ii), E has a $30,000 carryover to 1972 of 30-percent capital gain property, as defined in paragraph (d)(3) of §1.170A–8. For 1972 the amount of the charitable contributions deduction is $45,000 (total contributions of $50,000 [$30,000 + $20,000] but not to exceed 30% of $150,000).

(c) Assuming, however, that in 1972 E elects under section 170(b)(1)(D)(iii) and paragraph (d)(2) of §1.170A–8 to have section 170(e)(1)(B) apply to his contributions and carryovers of 30-percent capital gain property, he must apply section 170(d)(1) as if section 170(e)(1)(B) had applied to the contribution for 1971. If section 170 (e)(1)(B) had applied in 1971 to his contributions of 30-percent capital gain property, E's contribution would have been reduced from $90,000 to $50,000, the reduction of $40,000 being 50 percent of the gain of $80,000 ($90,000 − $10,000) which would have been recognized as long-term capital gain if the property had been sold by E at its fair market value at the time of its contribution to the church. Accordingly, by taking the election into account, E has no carryover of 30-percent capital gain property to 1972 since the charitable contributions deduction of $60,000 allowed for 1971 in respect of that property exceeds the reduced contribution of $50,000 for 1971 which may be taken into account by reason of the election. The charitable contributions deduction of $60,000 allowed for 1971 is not reduced by reason of the election.

(d) Since by reason of the election E is allowed under paragraph (a)(2) of this section a charitable contributions deduction for 1972 of $15,000 ($20,000 − [($20,000 − $10,000) × 50%]) and since the $30,000 carryover from 1971 is eliminated, it would not be to E's advantage to make the election under section 170(b)(1)(D)(iii) in 1972.

Example 5. In 1970, F, an individual calendar-year taxpayer, sells to a church for $4,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000, and F makes no other charitable contributions in 1970. Thus, F makes a charitable contribution to the church of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000/$10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under §1.1011–2(b) to the noncontributed portion of the property, and F recognizes $2,400 ($4,000 amount realized less $1,600 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,600 ($6,000 − [$4,000 adjusted basis × 60%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $2,400 consists of the portion ($4,000 × 60%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $6,400 ($4,000 + $2,400).

Example 6. In 1970, G, an individual calendar-year taxpayer, sells to a church for $6,000 ordinary income property with a fair market value of $10,000 and an adjusted basis of $4,000. G's contribution base for 1970 is $20,000, and G makes no other charitable contributions in 1970. Thus, G makes a charitable contribution to the church of $4,000 ($10,000 − $6,000 amount realized), which is 40% of the value of the property. The amount realized on the bargain sale is 60% ($6,000 / $10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $2,400 ($4,000 adjusted basis × 60%) is allocated under §1.1011–2(b) to the noncontributed portion of the property, and G recognizes $3,600 ($6,000 amount realized less $2,400 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, G's contribution of $4,000 is reduced by $2,400 ($4,000 − [$4,000 adjusted basis × 40%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $1,600 consist of the portion ($4,000 × 40%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $7,600 ($6,000 + $1,600).

Example 7. In 1970, H, an individual calendar-year taxpayer, sells to a church for $2,000 stock held for not more than 6 months which has an adjusted basis of $4,000 and a fair market value of $10,000. H's contribution base for 1970 is $20,000, and H makes no other charitable contributions in 1970. Thus, H makes a charitable contribution to the church of $8,000 ($10,000 − $2,000 amount realized), which is 80% of the value of the property. The amount realized on the bargain sale is 20% ($2,000 / $10,000) of the value of the property. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $800 ($4,000 adjusted basis × 20%) is allocated under §1.1011–2(b) to the noncontributed portion of the property, and H recognizes $1,200 ($2,000 amount realized less $800 adjusted basis) of ordinary income. Under paragraphs (a)(1) and (c)(2)(i) of this section, H's contribution of $8,000 is reduced by $4,800 ($8,000 − [$4,000 adjusted basis × 80%]) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,200 consists of the portion ($4,000 × 80%) of the adjusted basis not allocated to the noncontributed portion of the property. That is, the reduced contribution consists of the portion of the adjusted basis allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $5,200 ($2,000 + $3,200).

Example 8. In 1970, F, an individual calendar-year taxpayer, sells for $4,000 to a private foundation not described in section 170(b)(1)(E) property to which section 1245 applies which has a fair market value of $10,000 and an adjusted basis of $4,000. F's contribution base for 1970 is $20,000, and F makes no other charitable contributions in 1970. At the time of the bargain sale, F has used the property in his business for more than 6 months. Thus F makes a charitable contribution of $6,000 ($10,000 − $4,000 amount realized), which is 60% of the value of the property. The amount realized on the bargain sale is 40% ($4,000/$10,000) of the value of the property. If the property had been sold by F at its fair market value at the time of its contribution, it is assumed that under section 1245 $4,000 of the gain of $6,000 ($10,000 − $4,000 adjusted basis) would have been treated as ordinary income and $2,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $1,600 ($4,000 adjusted basis × 40%) is allocated under §1.1011–2(b) to the noncontributed portion of the property, and F's recognized gain of $2,400 ($4,000 amount realized less $1,600 adjusted basis) consists of $1,600 ($4,000 × 40%) of ordinary income and $800 ($2,000 × 40%) of long-term capital gain. Under paragraphs (a) and (c)(2)(i) of this section, F's contribution of $6,000 is reduced by $3,000 (the sum of $2,400 ($4,000 × 60%) of ordinary income and $600 ([$2,000 × 60%] × 50%) of long-term capital gain) (*i.e.*, the amount of gain that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $3,000 consists of $2,400 ($4,000 × 60%) of adjusted basis and $600 ([$2,000 × 60%] × 50%) of long-term capital gain not used as a reduction under paragraph (a)(2) of this section. Under sections 1012 and 1015(a) the basis of the property to the private foundation is $6,400 ($4,000 + $2,400).

Example 9. On January 1, 1970, A, an individual, transfers to a charitable remainder annuity trust described in section 664 (d)(1) stock which he has held for more than 6 months and which has a fair market value of $250,000 and an adjusted basis of $50,000, an irrevocable remainder interest in the property being contributed to a private foundation not described in section 170(b)(1)(E). The trusts provides that an annuity of $12,500 a year is payable to A at the end of each year for 20 years. By reference to §20.2031–7A(c) of this chapter (Estate Tax Regulations) the figure in column (2) opposite 20 years is 11.4699. Therefore, under §1.664–2 the fair market value of the gift of the remainder interest to charity is $106,626.25 ($250,000 − [$12,500 × 11.4699]). Under paragraph (c)(1)(ii) of this section, the adjusted basis allocated to the contributed portion of the property is $21,325.25 ($50,000 × $106,626.25/$250,000). Under paragraphs (a)(2) and (c)(1) of this section, A's contribution is reduced by $42,650.50 (50 percent × [$106,626.25 − $21,325.25]) to $63,975.75 ($106,626.25 − $42,650.50). If, however, the irrevocable remainder interest in the property had been contributed to a section 170(b)(1)(A) organization, A's contribution of $106,626.25 would not be reduced under paragraph (a) of this section.

Example 10. (a) On July 1, 1970, B, a calendar-year individual taxpayer, sells to a church for $75,000 intangible property to which section 1245 applies which has a fair market value of $250,000 and an adjusted basis of $75,000. Thus, B makes a charitable contribution to the church of $175,000 ($250,000 − $75,000 amount realized), which is 70% ($175,000/$250,000) of the value of the property, the amount realized on the bargain sale is 30% ($75,000/$250,000) of the value of the property. At the time of the bargain sale, B has used the property in his business for more than 6 months. B's contribution base for 1970 is $500,000, and B makes no other charitable contributions in 1970. If the property had been sold by B at its fair market value at the time of its contribution, it is assumed that under section 1245 $105,000 of the gain of $175,000 ($250,000 − $75,000 adjusted basis) would have been treated as ordinary income and $70,000 would have been long-term capital gain. In applying section 1011(b) to the bargain sale, adjusted basis in the amount of $22,500 ($75,000 adjusted basis × 30%) is allocated under §1.1011–2(b) to the noncontributed portion of the property and B's recognized gain of $52,500 ($75,000 amount realized less $22,500 adjusted basis) consists of $31,500 ($105,000 × 30%) of ordinary income and $21,000 ($70,000 × 30%) of long term capital gain.

(b) Under paragraphs (a)(1) and (c)(2)(i) of this section B's contribution of $175,000 is reduced by $73,500 ($105,000 × 70%) (*i.e.*, the amount of ordinary income that would have been recognized on the contributed portion had the property been sold). The reduced contribution of $101,500 consists of $52,500 [$75,000 × 70%] of adjusted basis allocated to the contributed portion of the property and $49,000 [$70,000 × 70%] of long-term capital gain allocated to the contributed portion. Under sections 1012 and 1015(a) the basis of the property to the church is $127,500 ($75,000 + $52,500).

(e) *Effective date.* This section applies only to contributions paid after December 31, 1969, except that, in the case of a charitable contribution of a letter, memorandum, or property similar to a letter or memorandum, it applies to contributions paid after July 25, 1969.

[T.D. 7207, 37 FR 20776, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980; T.D. 7807, 47 FR 4510, Feb. 1, 1982; T.D. 8176, 53 FR 5569, Feb. 25, 1988; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–4A Special rule for the deduction of certain charitable contributions of inventory and other property.

(a) *Introduction.* Section 170(e)(3) provides a special rule for the deduction of certain qualified contributions of inventory and certain other property. To be treated as a ''qualified contribution'', a contribution must meet the restrictions and requirements of section 170(e)(3)(A) and paragraph (b) of this section. Paragraph (b)(1) of this section describes the corporations whose contributions may be subject to this section, the exempt organizations to which these contributions may be made, and the kinds of property which may be contributed. Under paragraph (b)(2) of this section, the use of the property must be related to the purpose or function constituting the ground for the exemption of the organization to which the contribution is made. Also, the property must be used for the care of the ill, needy, or infants. Under paragraph (b)(3) of this section, the recipient organization may not, except as there provided, require or receive in exchange money, property, or services for the transfer or use of property contributed under section 170(e)(3). Under paragraph (b)(4) of this section, the recipient organization must provide the contributing taxpayer with a written statement representing that the organization intends to comply with the restrictions set forth in paragraph (b) (2) and (3) of this section on the use and transfer of the property. Under paragraph (b)(5) of this section, the contributed property must conform to any applicable provisions of the Federal Food, Drug, and Cosmetic Act (as amended), and the regulations thereunder, at the date of contribution and for the immediately preceding 180 days. Paragraph (c) of this section provides the rules for determining the amount of reduction of the charitable contribution under section 170(e)(3). In general, the amount of the reduction is equal to one-half of the amount of gain (other than gain described in paragraph (d) of this section) which would not have been long-term capital gain if the property had been sold by the donor-taxpayer at fair market value at the date of contribution. If, after this reduction, the amount of the deduction would be more than twice the basis of the contributed property, the amount of the deduction is accordingly further reduced under paragraph (c)(1) of this section. The basis of contributed property which is inventory is determined under paragraph (c)(2) of this section, and the donor's cost of goods sold for the year of contribution must be adjusted under paragraph (c)(3) of this section. Under paragraph (d) of this section, a deduction is not allowed for any amount which, if the property had been sold by the donor-taxpayer, would have been gain to which the recapture provisions of section 617, 1245, 1250, 1251, or 1252 would have applied. For purposes of section 170(e)(3) the rules of §1.170A–4 apply where not inconsistent with the rules of this section.

(b) *Qualified contributions*—(1) *In general*. A contribution of property qualifies under section 170(e)(3) of this section only if it is a charitable contribution:

(i) By a corporation, other than a corporation which is an electing small business corporation within the meaning of section 1371(b);

(ii) To an organization described in section 501(c)(3) and exempt under section 501(a), other than a private foundation, as defined in section 509(a), which is not an operating foundation, as defined in section 4942(j)(e);

(iii) Of property described in section 1221 (1) or (2);

(iv) Which contribution meets the restrictions and requirements of paragraph (b) (2) through (5) of this section.

(2) *Restrictions on use of contributed property*. In order for the contribution to qualify under this section, the contributed property is subject to the following restrictions in use. If the transferred property is used or transferred by the donee organization (or by any subsequent transferee that furnished to the donee organization the written statement described in paragraph (b)(4)(ii) of this section) in a manner inconsistent with the requirements of subdivision (i) or (ii) of this paragraph (b)(2) or the requirements of paragraph (b)(3) of this section, the donor's deduction is reduced to the amount allowable under section 170 of the regulations thereunder, determined without regard to section 170(e)(3) of this section. If, however, the donor establishes that, at the time of the contribution, the donor reasonably anticipated that the property would be used in a manner consistent with those requirements, then the donor's deduction is not reduced.

(i) *Requirement of use for exempt purpose*. The use of the property must be related to the purpose or function constituting the ground for exemption under section 501(c)(3) of the organization to which the contribution is made. The property may not be used in connection with any activity which gives rise to unrelated trade or business income, as defined in sections 512 and 513 and the regulations thereunder.

(ii) *Requirement of use for care of the ill, needy, or infants*—(A) *In general*. The property must be used for the care of the ill, needy, or infants, as defined in this subdivision (ii). The property itself must ultimately either be transferred to (or for the use of) the ill, needy, or infants for their care or be retained for their care. No other person may use the contributed property except as incidental to primary use in the care of the ill, needy, or infants. The organization may satisfy the requirement of this subdivision by transferring the property to a relative, custodian, parent or guardian of the ill or needy individual or infant, or to any other individual if it makes a reasonable effort to ascertain that the property will ultimately be used primarily for the care of the ill or needy individual, or infant, and not for the primary benefit of any other person. The recipient organization may transfer the property to another exempt organization within the jurisdiction of the United States which meets the description contained in paragraph (b)(1)(ii) of this section, or to an organization not within the jurisdiction of the United States that, but for the fact that it is not within the jurisdiction of the United States, would be described in paragraph (b)(1)(ii) of this section. If an organization transfers the property to another organization, the transferring organization must obtain a written statement from the transferee organization as set forth in paragraph (b)(4) of this section. If the property is ultimately transferred to, or used for the benefit of, ill or needy persons, or infants, not within the jurisdiction of the United States, the organization which so transfers the property outside the jurisdiction of the United States must necessarily be a corporation. See section 170(c)(2) and §1.170A–11(a). For purposes of this subdivision, if the donee-organization charges for its transfer of contributed property (other than a fee allowed by paragraph (b)(3)(ii) of this section), the requirement of this subdivision is not met. See paragraph (b)(3) of this section.

(B) *Definition of the ill.* An ill person is a person who requires medical care within the meaning of §1.213–1(e). Examples of ill persons include a person suffering from physical injury, a person with a significant impairment of a bodily organ, a person with an existing handicap, whether from birth or later injury, a person suffering from malnutrition, a person with a disease, sickness, or infection which significantly impairs physical health, a person partially or totally incapable of self-care (including incapacity due to old age). A person suffering from mental illness is included if the person is hospitalized or institutionalized for the mental disorder, or, although the person is nonhospitalized or noninstitutionalized, if the person's mental illness constitutes a significant health impairment.

(C) *Definition of care of the ill.* Care of the ill means alleviation or cure of an existing illness and includes care of the physical, mental, or emotional needs of the ill.

(D) *Definition of the needy.* A needy person is a person who lacks the necessities of life, involving physical, mental, or emotional well-being, as a result of poverty or temporary distress. Examples of needy persons include a person who is financially impoverished as a result of low income and lack of financial resources, a person who temporarily lacks food or shelter (and the means to provide for it), a person who is the victim of a natural disaster (such as fire or flood), a person who is the victim of a civil disaster (such as a civil disturbance), a person who is temporarily not self-sufficient as a result of a sudden and severe personal or family crisis (such as a person who is the victim of a crime of violence or who has been physically abused), a person who is a refugee or immigrant and who is experiencing language, cultural, or financial difficulties, a minor child who is not self-sufficient and who is not cared for by a parent or guardian, and a person who is not self-sufficient as a result of previous institutionalization (such as a former prisoner or a former patient in a mental institution).

(E) *Definition of care of the needy.* Care of the needy means alleviation or satisfaction of an existing need. Since a person may be needy in some respects and not needy in other respects, care of the needy must relate to the particular need which causes the person to be needy. For example, a person whose temporary need arises from a natural disaster may need temporary shelter and food but not recreational facilities.

(F) *Definition of infant.* An infant is a minor child (as determined under the laws of the jurisdiction in which the child resides).

(G) *Definition of care of an infant.* Care of an infant means performance of parental functions and provision for the physical, mental, and emotional needs of the infant.

(3) *Restrictions on Transfer of contributed property*—(i) *In general.* Except as otherwise provided in subdivision (ii) of this paragraph (b)(3), a contribution will not qualify under this section, if the donee-organization or any transferee of the donee-organization requires or receives any money, property, or services for the transfer or use of property contributed under section 170(e)(3). For example, if an organization provides temporary shelter for a fee, and also provides free meals to ill or needy individuals, or infants using food contributed under this section the contribution of food is subject to this section (if the other requirements of

this section are met). However, the fee charged by the organization for the shelter may not be increased merely because meals are served to the ill or needy individuals or infants.

(ii) *Exception.* A contribution may qualify under this section if the donee-organization charges a fee to another organization in connection with its transfer of the donated property, if:

(A) The fee is small or nominal in relation to the value of the transferred property and is not determined by this value; and

(B) The fee is designed to reimburse the donee-organization for its administrative, warehousing, or other similar costs.

For example, if a charitable organization (such as a food bank) accepts surplus food to distribute to other charities which give the food to needy persons, a small fee may be charged to cover administrative, warehousing, and other similar costs. This fee may be charged on the basis of the total number of pounds of food distributed to the transferee charity but not on the basis of the value of the food distributed. The provisions of this subdivision (ii) do not apply to a transfer of donated property directly from an organization to ill or needy individuals, or infants.

(4) *Requirement of a written statement*—(i) *Furnished to taxpayer.* In the case of any contribution made on or after March 3, 1982, the donee-organization must furnish to the taxpayer a written statement which:

(A) Describes the contributed property, stating the date of its receipt;

(B) Represents that the property will be used in compliance with section 170(e)(3) and paragraphs (b) (2) and (3) of this section;

(C) Represents that the donee-organization meets the requirements of paragraph (b)(1)(ii) of this section; and

(D) Represents that adequate books and records will be maintained, and made available to the Internal Revenue Service upon request.

The written statement must be furnished within a reasonable period after the contribution, but not later than the date (including extensions) by which the donor is required to file a United States corporate income tax return for the year in which the contribution was made. The books and records described in (D) of this subdivision (i) need not trace the receipt and disposition of specific items of donated property if they disclose compliance with the requirements by reference to aggregate quantities of donated property. The books and records are adequate if they reflect total amounts received and distributed (or used), and outline the procedure used for determining that the ultimate recipient of the property is an ill or needy individual, or infant. However, the books and records need not reflect the names of the ultimate individual recipients or the property distributed to (or used by) each one.

(ii) *Furnished to transferring organization.* If an organization that received a contribution under this section transfers the contributed property to another organization on or after March 3, 1982, the transferee organization must furnish to the transferring organization a written statement which contains the information required in paragraph (b)(4)(i) (A), (B) and (D) of this section. The statement must also represent that the transferee organization meets the requirements of paragraph (b)(1)(ii) of this section (or, in the case of a transferee organization which is a foreign organization not within the jurisdiction of the United States, that, but for such fact, the organization would meet the requirements of paragraph (b)(1)(ii) of this section). The written statement must be furnished within a reasonable period after the transfer.

(5) *Requirement of compliance with the Federal Food, Drug, and Cosmetic Act*—(i) *In general.* With respect to property contributed under this section which is subject to the Federal Food, Drug, and Cosmetic Act (as amended), and regulations thereunder, the contributed property must comply with the applicable provisions of that Act and regulations thereunder at the date of the contribution and for the immediately preceding 180 days. In the case of specific items of contributed property not in existence for the entire period of 180 days immediately preceding the date of contribution, the requirement of this paragraph (b)(5) is considered met if the contributed property complied with that Act

and the regulations thereunder during the period of its existence and at the date of contribution and if, for the 180 day period prior to contribution other property (if any) held by the taxpayer at any time during that period, which property was fungible with the contributed property, complied with that Act and the regulations thereunder during the period held by the taxpayer.

(ii) *Example.* The rule of this paragraph (b)(5) may be illustrated by the following example.

Example. Corporation X a grocery store, contributes 12 crates of navel oranges. The oranges were picked and placed in the grocery store's stock two weeks prior to the date of contribution. The contribution satisfies the requirements of this paragraph (b)(5) if X complied with the Act and regulations thereunder for 180 days prior to the date of contribution with respect to all navel oranges in stock during that period.

(c) *Amount of reduction*—(1) *In general.* Section 170(e)(3)(B) requires that the amount of the charitable contribution subject to this section which would be taken into account under section 170(a), without regard to section 170(e), must be reduced before applying the percentage limitations under section 170(b). The amount of the first reduction is equal to one-half of the amount of gain which would not have been long-term capital gain if the property had been sold by the donor-taxpayer at its fair market value on the date of its contribution, excluding, however, any amount described in paragraph (d) of this section. If the amount of the charitable contribution which remains after this reduction exceeds twice the basis of the contributed property, then the amount of the charitable contribution is reduced a second time to an amount which is equal to twice the amount of the basis of the property.

(2) *Basis of contributed property which is inventory.* For the purposes of this section, notwithstanding the rules of §1.170A–1(c)(4), the basis of contributed property which is inventory must be determined under the donor's method of accounting for inventory for purposes of United States income tax. The donor must use as the basis of the contributed item the inventoriable carrying cost assigned to any similar item not included in closing inventory. For example, under the LIFO dollar value method of accounting for inventory, where there has been an invasion of a prior year's layer, the donor may choose to treat the item contributed as having a basis of the unit's cost with reference to the layer(s) of prior year(s) cost or with reference to the current year cost.

(3) *Adjustment to cost of goods sold.* Notwithstanding the rules of §1.170A–1(c)(4), the donor of the property which is inventory contributed under this section must make a corresponding adjustment to cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the contributed item or the amount of basis determined under paragraph (c)(2) of this section.

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

Example 1. During 1978 corporation X, a calendar year taxpayer, makes a qualified contribution of women's coats which were section 1221(1) property. The fair market value of the property at the date of contribution is $1,000, and the basis of the property is $200. The amount of the charitable contribution which would be taken into account under section 170(a) is the fair market value ($1,000). The amount of gain which would not have been long-term capital gain if the property had been sold is $800 ($1,000 − $200). The amount of the contribution is reduced by one-half the amount which would not have been capital gain if the property had been sold ($800/2=–$400).

After this reduction, the amount of the contribution which may be taken into account is $600 ($1,000 − $400). A second reduction is made in the amount of the charitable contribution because this amount (as first reduced to $600) is more than $400 which is an amount equal to twice the basis of the property. The amount of the further reduction is $200 [$600 − (2 × $200)], and the amount of the contribution as finally reduced is $400 [$1,00 − ($400 + $200)]. X would also have to decrease its cost of goods sold for the year of contribution by $200.

Example 2. Assume the same facts as set forth in *Example 1* except that the basis of the property is $600. The amount of the first reduction is $200 (($1,000 − $600)/2).

As reduced, the amount of the contribution which may be taken into account is $800 ($1,000 − $200). There is no second reduction because $800 is less than $1,200 which is twice the basis of the property. However, X would have to decrease its cost of goods sold for the year of contribution by $600.

(d) *Recapture excluded.* A deduction is not allowed under section 170(e)(3) or this section for any amount which, if the property had been sold by the donor-taxpayer on the date of its contribution for an amount equal to its fair market value, would have been treated as ordinary income under section 617, 1245, 1250, 1251, or 1252. Thus, before making either reduction required by section 170(e)(3)(B) and paragraph (c) of this section, the fair market value of the contributed property must be reduced by the amount of gain that would have been recognized (if the property had been sold) as ordinary income under section 617, 1245, 1250, 1251, or 1252.

(e) *Effective date.* This section applies to qualified contributions made after October 4, 1976.

[T.D. 7807, 47 FR 4510, Feb. 1, 1982, as amended by T.D. 7962, 49 FR 27317, July 3, 1984]

§ 1.170A–5 Future interests in tangible personal property.

(a) *In general.* (1) A contribution consisting of a transfer of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property:

(i) Have expired, or

(ii) Are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) and the regulations thereunder, relating to losses, expenses, and interest with respect to transactions between related taxpayers.

(2) Section 170(a)(3) and this section have no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during 3 months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than 1 year.

(3) Section 170(a)(3) and this section have no application in respect of a transfer of a future interest in intangible personal property or in real property. However, a fixture which is intended to be severed from real property shall be treated as tangible personal property. For example, a contribution of a future interest in a chandelier which is attached to a building is considered a contribution which consists of a future interest in tangible personal property if the transferor intends that it be detached from the building at or prior to the time when the charitable organization's right to possession or enjoyment of the chandelier is to commence.

(4) For purposes of section 170(a)(3) and this section, the term *future interest* has generally the same meaning as it has when used in section 2503 and §25.2503–3 of this chapter (Gift Tax Regulations); it includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. The term *future interest* includes situations in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property.

(5) In the case of a charitable contribution of a future interest to which section 170(a)(3) and this section apply the other provisions of section 170 and the regulations thereunder are inapplicable to the contribution until such time as the contribution is treated as made under section 170(a)(3).

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

Example 1. On December 31, 1970, A, an individual who reports his income on the calendar year basis, conveys by deed of gift to a museum title to a painting, but reserves to himself the right to the use, possession, and enjoyment of the painting during his lifetime. It is assumed that there was no intention to avoid the application of section 170(f)(3)(A) by the conveyance. At the time of the gift the value of the painting is $90,000. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no contribution is considered to have been made in 1970.

Example 2. Assume the same facts as in *Example 1* except that on December 31, 1971, A relinquishes all of his right to the use, possession, and enjoyment of the painting and delivers the painting to the museum. Assuming that the value of the painting has increased to $95,000, A is treated as having made a charitable contribution of $95,000 in 1971 for which a deduction is allowable without regard to section 170(f)(3)(A).

Example 3. Assume the same facts as in *Example 1* except A dies without relinquishing his right to the use, possession, and enjoyment of the painting. Since A did not relinquish his right to the use, possession, and enjoyment of the property during his life, A is treated as not having made a charitable contribution of the painting for income tax purposes.

Example 4. Assume the same facts as in *Example 1* except A, on December 31, 1971, transfers his interest in the painting to his son, B, who reports his income on the calendar year basis. Since the relationship between A and B is one described in section 267(b), no contribution of the remainder interest in the painting is considered to have been made in 1971.

Example 5. Assume the same facts as in *Example 4.* Also assume that on December 31, 1972, B conveys to the museum the interest measured by A's life. B has made a charitable contribution of the present interest in the painting conveyed to the museum. In addition, since all intervening interests in, and rights to the actual possession or enjoyment of the property, have expired, a charitable contribution of the remainder interest is treated as having been made by A in 1972 for which a deduction is allowable without regard to section 170(f)(3)(A). Such remainder interest is valued according to §20.2031–7A(c) of this chapter (estate tax regulations), determined by subtracting the value of B's interest measured by A's life expectancy in 1972, and B receives a deduction in 1972 for the life interest measured by A's life expectancy and valued according to Table A(1) in such section.

Example 6. On December 31, 1970, C, an individual who reports his income on the calendar year basis, transfers a valuable painting to a pooled income fund described in section 642(c)(5), which is maintained by a university. C retains for himself for life an income interest in the painting, the remainder interest in the painting being contributed to the university. Since the contribution consists of a future interest in tangible personal property in which the donor has retained an intervening interest, no charitable contribution is considered to have been made in 1970.

Example 7. On January 15, 1972, D, an individual who reports his income on the calendar year basis, transfers a capital asset held for more than 6 months consisting of a valuable painting to a pooled income fund described in section 642(c)(5), which is maintained by a university, and creates an income interest in such painting for E for life. E is an individual not standing in a relationship to D described in section 267(b). The remainder interest in the property is contributed by D to the university. The trustee of the pooled income fund puts the painting to an unrelated use within the meaning of paragraph (b)(3) of §1.170A–4. Accordingly, D is allowed a deduction under section 170 in 1972 for the present value of the remainder interest in the painting, after reducing such amount under section 170 (e)(1)(B)(i) and paragraph (a)(2) of §1.170A–4. This reduction in the amount of the contribution is required since under paragraph (b)(3) of that section the use by the pooled income fund of the painting is a use which would have been an unrelated use if it had been made by the university.

(c) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20779, Oct. 4, 1972, as amended by T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–6 Charitable contributions in trust.

(a) *In general.* (1) No deduction is allowed under section 170 for the fair market value of a charitable contribution of any interest in property which is less than the donor's entire interest in the property and which is transferred in trust unless the transfer meets the requirements of paragraph (b) or (c) of this section. If the donor's entire interest in the property is transferred in trust and is contributed to a charitable organization described in section 170(c), a deduction is allowed under section 170. Thus, if on July 1, 1972, property is transferred in trust with the requirement that the income of the trust be paid for a term of 20 years to a church and thereafter the remainder be paid to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property. See section 170(f)(2) and (3)(B), and paragraph (b)(1) of §1.170A–7.

(2) A deduction is allowed without regard to this section for a contribution

of a partial interest in property if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(2), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds which he owns. If the taxpayer transfers such property in trust with the requirement that the income of the trust be paid to his son for life and that the reversionary interest be paid to himself and immediately after creating the trust contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest in the trust.

(b) *Charitable contribution of a remainder interest in trust*—(1) *In general.* No deduction is allowed under section 170 for the fair market value of a charitable contribution of a remainder interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust unless the trust is:

(i) A pooled income fund described in section 642(c)(5) and §1.642(c)–5,

(ii) A charitable remainder annuity trust described in section 664(d)(1) and §1.664–2, or

(iii) A charitable remainder unitrust described in section 664(d)(2) and §1.664–3.

(2) *Value of a remainder interest.* The fair market value of a remainder interest in a pooled income fund shall be computed under §1.642(c)–6. The fair market value of a remainder interest in a charitable remainder annuity trust shall be computed under §1.664–2. The fair market value of a remainder interest in a charitable remainder unitrust shall be computed under §1.664–4. However, in some cases a reduction in the amount of a charitable contribution of the remainder interest may be required. See section 170(e) and §1.170A–4.

(c) *Charitable contribution of an income interest in trust*—(1) *In general.* No deduction is allowed under section 170 for the fair market value of a charitable contribution of an income interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust unless the income interest is either a guaranteed annuity interest or a unitrust interest, as defined in paragraph (c)(2) of this section, and the grantor is treated as the owner of such interest for purposes of applying section 671, relating to grantors and others treated as substantial owners. See section 4947(a)(2) for the application to such income interests in trust of the provisions relating to private foundations and section 508(e) for rules relating to provisions required in the governing instruments.

(2) *Definitions.* For purposes of this paragraph:

(i) *Guaranteed annuity interest.* (A) An income interest is a ''guaranteed annuity interest'' only if it is an irrevocable right pursuant to the governing instrument of the trust to receive a guaranteed annuity. A guaranteed annuity is an arrangement under which a determinable amount is paid periodically, but not less often than annually, for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of transfer and can be ascertained at such date. Only one or more of the following individuals may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in section 170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus. This probability must be computed, based on the current applicable Life Table contained in §20.2031–7, at the time property is transferred to the trust taking into account the interests of all primary and contingent remainder beneficiaries who are living at that time. An interest payable for a specified term of years can qualify as a guaranteed annuity interest even if the governing instrument contains a savings clause intended to ensure compliance with a rule against perpetuities. The savings clause must utilize a period for vesting of 21 years after the deaths of measuring lives who are selected to maximize, rather than limit, the term of the trust. The rule in this paragraph that a charitable interest may be payable for the life or lives of only certain specified individuals does not apply in the case of a charitable guaranteed annuity interest payable under a charitable remainder trust described in section 664. An amount is determinable if the exact amount which must be paid under the conditions specified in the governing instrument of the trust can be ascertained as of the date of transfer. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the donor, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed in terms of a fraction or percentage of the cost of living index on the date of transfer.

(B) An income interest is a guaranteed annuity interest only if it is a guaranteed annuity interest in every respect. For example, if the income interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a guaranteed annuity interest.

(C) Where a charitable interest is in the form of a guaranteed annuity interest, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the guaranteed annuity interest shall be paid to or for the use of a charitable organization. Nevertheless, the amount of the deduction under section 170(f)(2)(B) shall be limited to the fair market value of the guaranteed annuity interest as determined under paragraph (c)(3) of this section. For a rule relating to treatment by the grantor of any contribution made by the trust in excess of the amount required to pay the guaranteed annuity interest, see paragraph (d)(2)(ii) of this section.

(D) If the present value on the date of transfer of all the income interests for a charitable purpose exceeds 60 percent of the aggregate fair market value of all amounts in the trust (after the payment of liabilities), the income interest will not be considered a guaranteed annuity interest unless the governing instrument of the trust prohibits both the acquisition and the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired such assets. The requirement in this subdivision (D) for a prohibition in the governing instrument against the retention of assets which would give rise to a tax under section 4944 if the trustee had acquired the assets shall not apply to a transfer in trust made on or before May 21, 1972.

(E) Where a charitable interest in the form of a guaranteed annuity interest is transferred after May 21, 1972, the charitable interest generally is not a guaranteed annuity interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable annuity interests. There are two exceptions to this general rule. First, the charitable interest is a guaranteed annuity interest if the amount payable for a private purpose is in the form of a guaranteed annuity interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private annuity as opposed to the charitable annuity. Second, the charitable interest is a guaranteed annuity interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(i)(E), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See §53.4947–1(c) of this chapter for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

(F) For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the guaranteed annuity interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(ii) *Unitrust interest.* (A) An income interest is a ''unitrust interest'' only if it is an irrevocable right pursuant to the governing instrument of the trust to receive payment, not less often than annually of a fixed percentage of the net fair market value of the trust assets, determined annually. In computing the net fair market value of the trust assets, all assets and liabilities shall be taken into account without regard to whether particular items are taken into account in determining the income of the trust. The net fair market value of the trust assets may be determined on any one date during the year or by taking the average of valuations made on more than one date during the year, provided that the same valuation date or dates and valuation methods are used each year. Where the governing instrument of the trust does not specify the valuation date or dates, the trustee shall select such date or dates and shall indicate his selection on the first return on Form 1041 which the trust is required to file. Payments under a unitrust interest may be paid for a specified term of years or for the life or lives of certain individuals, each of whom must be living at the date of transfer and can be ascertained at such date. Only one or more of the following individuals may be used as measuring lives: the donor, the donor's spouse, and an individual who, with respect to all remainder beneficiaries (other than charitable organizations described in section 170, 2055, or 2522), is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries. A trust will satisfy the requirement that all noncharitable remainder beneficiaries are lineal descendants of the individual who is the measuring life, or that individual's spouse, if there is less than a 15% probability that individuals who are not lineal descendants will receive any trust corpus. This probability must be computed, based on the current applicable Life Table contained in §20.2031–7, at the time property is transferred to the trust taking into account the interests of all primary and contingent remainder beneficiaries who are living at that time. An interest payable for a specified term of years can qualify as a unitrust interest even if the governing instrument contains a savings clause intended to ensure compliance with a rule against perpetuities. The savings clause must utilize a period for vesting of 21 years after the deaths of measuring lives who are selected to maximize, rather than limit, the term of the trust. The rule in this paragraph that a charitable interest may be payable for the life or lives of only certain specified individuals does not apply in the case of a charitable unitrust interest payable under a charitable remainder trust described in section 664.

(B) An income interest is a unitrust interest only if it is a unitrust interest in every respect. For example, if the income interest is the right to receive from a trust each year a payment equal to the lesser of a sum certain or a fixed percentage of the net fair market value of the trust assets, determined annually, such interest is not a unitrust interest.

(C) Where a charitable interest is in the form of a unitrust interest, the governing instrument of the trust may provide that income of the trust which is in excess of the amount required to pay the unitrust interest shall be paid to or for the use of a charitable organization. Nevertheless, the amount of the deduction under section 170(f)(2)(B) shall be limited to the fair market value of the unitrust interest as determined under paragraph (c)(3) of this section. For a rule relating to treatment by the grantor of any contribution made by the trust in excess of the amount required to pay the unitrust interest, see paragraph (d)(2)(ii) of this section.

(D) Where a charitable interest is in the form of a unitrust interest, the charitable interest generally is not a unitrust interest if any amount may be paid by the trust for a private purpose before the expiration of all the charitable unitrust interests. There are two exceptions to this general rule. First, the charitable interest is a unitrust interest if the amount payable for a private purpose is in the form of a unitrust interest and the trust's governing instrument does not provide for any preference or priority in the payment of the private unitrust interest as opposed to the charitable unitrust interest. Second, the charitable interest is a unitrust interest if under the trust's governing instrument the amount that may be paid for a private purpose is payable only from a group of assets that are devoted exclusively to private purposes and to which section 4947(a)(2) is inapplicable by reason of section 4947(a)(2)(B). For purposes of this paragraph (c)(2)(ii)(D), an amount is not paid for a private purpose if it is paid for an adequate and full consideration in money or money's worth. See §53.4947–1(c) of this chapter for rules relating to the inapplicability of section 4947(a)(2) to segregated amounts in a split-interest trust.

(E) For rules relating to certain governing instrument requirements and to the imposition of certain excise taxes where the unitrust interest is in trust and for rules governing payment of private income interests by a split-interest trust, see section 4947(a)(2) and (b)(3)(A), and the regulations thereunder.

(3) *Valuation of income interest.* (i) The deduction allowed by section 170(f)(2)(B) for a charitable contribution of a guaranteed annuity interest is limited to the fair market value of such interest on the date of contribution, as computed under §20.2031–7 or, for certain prior periods, 20.2031–7A of this chapter (Estate Tax Regulations).

(ii) The deduction allowed under section 170(f)(2)(B) for a charitable contribution of a unitrust interest is limited to the fair market value of the unitrust interest on the date of contribution. The fair market value of the unitrust interest shall be determined by subtracting the present value of all interests in the transferred property other than the unitrust interest from the fair market value of the transferred property.

(iii) If by reason of all the conditions and circumstances surrounding a transfer of an income interest in property in trust it appears that the charity may not receive the beneficial enjoyment of the interest, a deduction will be allowed under paragraph (c)(1) of this section only for the minimum amount it is evident the charity will receive. The application of this subdivision may be illustrated by the following examples:

Example 1. In 1972, B transfers $20,000 in trust with the requirement that M Church be paid a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $4,000, payable annually at the end of each year for 9 years, and that the residue revert to himself. Since the fair market value of an annuity of $4,000 a year for a period of 9 years, as determined under §20.2031–7A(c) of this chapter, is $27,206.80 ($4,000 × 6.8017), it appears that M will not receive the beneficial enjoyment of the income interest. Accordingly, even though B is treated as the owner of the trust under section 673, he is allowed a deduction under subparagraph (1) of this paragraph for only $20,000, which is the minimum amount it is evident M will receive.

Example 2. In 1975, C transfers $40,000 in trust with the requirement that D, an individual, and X Charity be paid simultaneously guaranteed annuity interests (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year each, payable annually at the end of each year, for a period of 5 years and that the remainder be paid to C's children. The fair market value of two annuities of $5,000 each a year for a period of 5 years is $42,124 ([$5,000 × 4.2124] × 2), as determined under §20.2031–7A(c) of this chapter. The trust instrument provides that in the event the trust fund is insufficient to pay both annuities in a given year, the trust fund will be evenly divided between the charitable and private annuitants. The deduction under subparagraph (1) of this paragraph with respect to the charitable annuity will be limited to $20,000, which is the minimum amount it is evident X will receive.

Example 3. In 1975, D transfers $65,000 in trust with the requirement that a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year, payable annually at the end of each year, be paid to Y Charity for a period of 10 years and that a guaranteed annuity interest (as defined in subparagraph (2)(i) of this paragraph) of $5,000 a year, payable annually at the end of each year, be paid to W, his wife, aged 62, for 10 years or until her prior death. The annuities are to be paid simultaneously, and the remainder is to be paid to D's children. The fair market value of the private annuity is $33,877 ($5,000 × 6.7754), as determined pursuant to § 20.2031–7A(c) of this chapter and by the use of factors involving one life and a term of years as published in Publication 723A (12–70). The fair market value of the charitable annuity is $36,800.50 ($5,000 × 7.3601), as determined under § 20.2031–7A(c) of this chapter. It is not evident from the governing instrument of the trust or from local law that the trustee would be required to apportion the trust fund between the wife and charity in the event the fund were insufficient to pay both annuities in a given year. Accordingly, the deduction under subparagraph (1) of this paragraph with respect to the charitable annuity will be limited to $31,123 ($65,000 less $33,877 [the value of the private annuity]), which is the minimum amount it is evident Y will receive.

(iv) See paragraph (b)(1) of § 1.170A–4 for rule that the term *ordinary income property* for purposes of section 170(e) does not include an income interest in respect of which a deduction is allowed under section 170(f)(2)(B) and this paragraph.

(4) *Recapture upon termination of treatment as owner.* If for any reason the donor of an income interest in property ceases at any time before the termination of such interest to be treated as the owner of such interest for purposes of applying section 671, as for example, where he dies before the termination of such interest, he shall for purposes of this chapter be considered as having received, on the date he ceases to be so treated, an amount of income equal to (i) the amount of any deduction he was allowed under section 170 for the contribution of such interest reduced by (ii) the discounted value of all amounts which were required to be, and actually were, paid with respect to such interest under the terms of trust to the charitable organization before the time at which he ceases to be treated as the owner of the interest. The discounted value of the amounts described in subdivision (ii) of this subparagraph shall be computed by treating each such amount as a contribution of a remainder interest after a term of years and valuing such amount as of the date of contribution of the income interest by the donor, such value to be determined under § 20.2031–7 of this chapter consistently with the manner in which the fair market value of the income interest was determined pursuant to subparagraph (3)(i) of this paragraph. The application of this subparagraph will not be construed to disallow a deduction to the trust for amounts paid by the trust to the charitable organization after the time at which the donor ceased to be treated as the owner of the trust.

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

Example 1. On January 1, 1971, A contributes to a church in trust a 9-year irrevocable income interest in property. Both A and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the church will receive an annuity of $500, payable annually at the end of each year for 9 years. The income interest is a guaranteed annuity interest as defined in subparagraph (2)(i) of this paragraph; upon termination of such interest the residue of the trust is to revert to A. By reference to § 20.2031–7A(c) of this chapter, it is found that the figure in column (2) opposite 9 years is 6.8017. The present value of the annuity is therefore $3,400.85 ($500 × 6.8017). The present value of the income interest and A's charitable contribution for 1971 is $3,400.85.

Example 2. (a) On January 1, B contributes to a church in trust a 9-year irrevocable income interest in property. Both B and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the trust will pay to the church at the end of each year for 9 years 5 percent of the fair market value of all property in the trust at the beginning of the year. The income interest is a unitrust interest as defined in subparagraph (2)(ii) of this paragraph; upon termination of such interest the residue of the trust is to revert to B.

(b) The section 7520 rate at the time of the transfer was 6.0 percent. By reference to Table F(6.0) in § 1.664–4(e)(6), the adjusted payout rate is 4.717% (5% × 0.943396). The present value of the reversion is $6,473.75, computed by reference to Table D in § 1.664–4(e)(6), as follows:

Factor at 4.6 percent for 9 years	0.654539
Factor at 4.8 percent for 9 years	.642292
Difference	.012247

Interpolation adjustment:

$$4.717\% - 4.6\% / 0.2\% = \times / 0.012247$$
$$\times = 0.007164$$

Factor at 4.6 percent for 9 years	.654539
Less: Interpolation adjustment	.007164
Interpolated factor	.647375
Present value of reversion ($10,000 × 0.647375)	$6,473.75

(c) The present value of the income interest and B's charitable contribution is $3,526.25 ($10,000 − $6,473.75).

Example 3. (a) On January 1, 1971, C contributes to a church in trust a 9-year irrevocable income interest in property. Both C and the trust report income on a calendar year basis. The fair market value of the property placed in trust is $10,000. The trust instrument provides that the church will receive an annuity of $500, payable annually at the end of each year for 9 years. The income interest is a guaranteed annuity interest as defined in subparagraph (2)(i) of this paragraph; upon termination of such interest the residue of the trust is to revert to C. C's charitable contribution for 1971 is $3,400.85, determined as provided in *Example 1.* The trust earns income of $600 in 1971, $400 in 1972, and $500 in 1973, all of which is taxable to C under section 671. The church is paid $500 at the end of 1971, 1972, and 1973, respectively. On December 31, 1973, C dies and ceases to be treated as the owner of the income interest under section 673.

(b) Pursuant to subparagraph (4) of this paragraph, the discounted value as of January 1, 1971, of the amounts paid to the church by the trust is $1,336.51, determined by reference to column (4) of §20.2031–7A(c) of this chapter, as follows:

Annuity				
Payment date	Amount paid	Years from Jan. 1, 1971, to payment date	Discount factor	Discount value as of Jan. 1, 1971
Dec. 31, 1971	$500	1	0.943396	$471.70
Dec. 31, 1972	500	2	.889996	445.00
Dec. 31, 1973	500	3	.839619	419.81
Total discounted value				1,336.51

(c) Pursuant to subparagraph (4) of this paragraph, there must be included in C's gross income for 1973 the amount of $2,064.34 ($3,400.85 less $1,336.51).

(d) For deduction by the trust for amounts paid to the church after December 31, 1973, see section 642(c)(1) and the regulations thereunder.

(d) *Denial of deduction for certain contributions by a trust.* (1) If by reason of section 170(f)(2)(B) and paragraph (c) of this section a charitable contributions deduction is allowed under section 170 for the fair market value of an income interest transferred in trust, neither the grantor of the income interest, the trust, nor any other person shall be allowed a deduction under section 170 or any other section for the amount of any charitable contribution made by the trust with respect to, or in fulfillment of, such income interest.

(2) Section 170(f)(2)(C) and subparagraph (1) of this paragraph shall not be construed, however, to:

(i) Disallow a deduction to the trust, pursuant to section 642(c)(1) and the regulations thereunder, for amounts paid by the trust after the grantor ceases to be treated as the owner of the income interest for purposes of applying section 671 and which are not taken into account in determining the amount of recapture under paragraph (c)(4) of this section, or

(ii) Disallow a deduction to the grantor under section 671 and §1.671–2(c) for a charitable contribution made by the trust in excess of the contribution required to be made by the trust under the terms of the trust instrument with respect to, or in fulfillment of, the income interest.

(3) Although a deduction for the fair market value of an income interest in property which is less than the donor's entire interest in the property and which the donor transfers in trust is disallowed under section 170 because such interest is not a guaranteed annuity interest, or a unitrust interest, as defined in paragraph (c)(2) of this section, the donor may be entitled to a deduction under section 671 and §1.671–2(c) for any charitable contributions made by the trust if he is treated as the owner of such interest for purposes of applying section 671.

(e) *Effective date.* This section applies only to transfers in trust made after July 31, 1969. In addition, the rule in paragraphs (c)(2)(i)(A) and (ii)(A) of this section that guaranteed annuity interests and unitrust interests, respectively, may be payable for a specified term of years or for the life or lives of only certain individuals applies to transfers made on or after April 4, 2000. If a transfer is made to a trust on or after April 4, 2000 that uses an individual other than one permitted in paragraphs (c)(2)(i)(A) and (ii)(A) of this section, the trust may be reformed to satisfy this rule. As an alternative to reformation, rescission may be available for a transfer made on or before March 6, 2001. See §25.2522(c)–3(e) of this chapter for the requirements concerning reformation or possible rescission of these interests.

[T.D. 7207, 37 FR 20780, Oct. 5, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7340, 40 FR 1238, Jan. 7, 1975; T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8540, 59 FR 30102, June 10, 1994; T.D. 8819, 64 FR 23189, 23228, Apr. 30, 1999; 64 FR 33196, June 22, 1999; T.D. 8923, 66 FR 1041, Jan. 5, 2001; T.D. 9068, 68 FR 40131, July 7, 2003]

§ 1.170A–7 Contributions not in trust of partial interests in property.

(a) *In general.* (1) In the case of a charitable contribution, not made by a transfer in trust, of any interest in property which consists of less than the donor's entire interest in such property, no deduction is allowed under section 170 for the value of such interest unless the interest is an interest described in paragraph (b) of this section. See section 170(f)(3)(A). For purposes of this section, a contribution of the right to use property which the donor owns, for example, a rent-free lease, shall be treated as a contribution of less than the taxpayer's entire interest in such property.

(2)(i) A deduction is allowed without regard to this section for a contribution of a partial interest in property if such interest is the taxpayer's entire interest in the property, such as an income interest or a remainder interest. Thus, if securities are given to A for life, with the remainder over to B, and B makes a charitable contribution of his remainder interest to an organization described in section 170(c), a deduction is allowed under section 170 for the present value of B's remainder interest in the securities. If, however, the property in which such partial interest exists was divided in order to create such interest and thus avoid section 170(f)(3)(A), the deduction will not be allowed. Thus, for example, assume that a taxpayer desires to contribute to a charitable organization an income interest in property held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer transfers the remainder interest in such property to his son and immediately thereafter contributes the income interest to a charitable organization, no deduction shall be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the retained income interest. In further illustration, assume that a taxpayer desires to contribute to a charitable organization the reversionary interest in certain stocks and bonds held by him, which is not of a type described in paragraph (b)(2) of this section. If the taxpayer grants a life estate in such property to his son and immediately thereafter contributes the reversionary interest to a charitable organization, no deduction will be allowed under section 170 for the contribution of the taxpayer's entire interest consisting of the reversionary interest.

(ii) A deduction is allowed without regard to this section for a contribution of a partial interest in property if such contribution constitutes part of a charitable contribution not in trust in which all interests of the taxpayer in the property are given to a charitable organization described in section 170(c). Thus, if on March 1, 1971, an income interest in property is given not in trust to a church and the remainder interest in the property is given not in trust to an educational organization described in section 170(b)(1)(A), a deduction is allowed for the value of such property.

(3) A deduction shall not be disallowed under section 170(f)(3)(A) and this section merely because the interest which passes to, or is vested in, the charity may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. See paragraph (e) of §1.170A–1.

(b) *Contributions of certain partial interests in property for which a deduction is allowed.* A deduction is allowed under section 170 for a contribution not in trust of a partial interest which is less than the donor's entire interest in property and which qualifies under one of the following subparagraphs:

(1) *Undivided portion of donor's entire interest.* (i) A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an undivided portion of a donor's entire interest in property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted. For example, assuming that in 1967 B has been given a life estate in an office building for the life of A and that B has no other interest in the office building, B will be allowed a deduction under section 170 for his contribution in 1972 to charity of a one-half interest in such life estate in a transfer which is not made in trust. Such contribution by B will be considered a contribution of an undivided portion of the donor's entire interest in property. In further illustration, assuming that in 1968 C has been given the remainder interest in a trust created under the will of his father and C has no other interest in the trust, C will be allowed a deduction under section 170 for his contribution in 1972 to charity of a 20-percent interest in such remainder interest in a transfer which is not made in trust. Such contribution by C will be considered a contribution of an undivided portion of the donor's entire interest in property. If a taxpayer owns 100 acres of land and makes a contribution of 50 acres to a charitable organization, the charitable contribution is allowed as a deduction under section 170. A deduction is allowed under section 170 for a contribution of property to a charitable organization whereby such organization is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property. However, for purposes of this subparagraph a charitable contribution in perpetuity of an interest in property not in trust where the donor transfers some specific rights and retains other substantial rights will not be considered a contribution of an undivided portion of the donor's entire interest in property to which section 170(f)(3)(A) does not apply. Thus, for example, a deduction is not allowable for the value of an immediate and perpetual gift not in trust of an interest in original historic motion picture films to a charitable organization where the donor retains the exclusive right to make reproductions of such films and to exploit such reproductions commercially.

(ii) With respect to contributions made on or before December 17, 1980, for purposes of this subparagraph a charitable contribution of an open space easement in gross in perpetuity shall be considered a contribution of an undivided portion of the donor's entire interest in property to which section 170(f)(3)(A) does not apply. For this purpose an easement in gross is a mere personal interest in, or right to use, the land of another; it is not supported by a dominant estate but is attached to, and vested in, the person to whom it is granted. Thus, for example, a deduction is allowed under section 170 for the value of a restrictive easement gratuitously conveyed to the United States in perpetuity whereby the donor agrees to certain restrictions on the use of his property, such as, restrictions on the type and height of buildings that may be erected, the removal of trees, the erection of utility lines, the dumping of trash, and the use of signs. For the deductibility of a qualified conservation contribution, see §1.170A–14.

(2) *Partial interests in property which would be deductible in trust.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of a partial interest in property which is less than the donor's entire interest in the property and which would be deductible under section 170(f)(2) and §1.170A–6 if such interest had been transferred in trust.

(3) *Contribution of a remainder interest in a personal residence.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an irrevocable remainder interest in a personal residence which is not the donor's entire interest in such

property. Thus, for example, if a taxpayer contributes not in trust to an organization described in section 170(c) a remainder interest in a personal residence and retains an estate in such property for life or for a term of years, a deduction is allowed under section 170 for the value of such remainder interest not transferred in trust. For purposes of section 170(f)(3)(B)(i) and this subparagraph, the term *personal residence* means any property used by the taxpayer as his personal residence even though it is not used as his principal residence. For example, the taxpayer's vacation home may be a personal residence for purposes of this subparagraph. The term *personal residence* also includes stock owned by a taxpayer as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b) (1) and (2)) if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his personal residence.

(4) *Contribution of a remainder interest in a farm.* A deduction is allowed under section 170 for the value of a charitable contribution not in trust of an irrevocable remainder interest in a farm which is not the donor's entire interest in such property. Thus, for example, if a taxpayer contributes not in trust to an organization described in section 170(c) a remainder interest in a farm and retains an estate in such farm for life or for a term of years, a deduction is allowed under section 170 for the value of such remainder interest not transferred in trust. For purposes of section 170(f)(3)(B)(i) and this subparagraph, the term *farm* means any land used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. A farm includes the improvements thereon.

(5) *Qualified conservation contribution.* A deduction is allowed under section 170 for the value of a qualified conservation contribution. For the definition of a qualified conservation contribution, see § 1.170A–14.

(c) *Valuation of a partial interest in property.* Except as provided in § 1.170A–14, the amount of the deduction under section 170 in the case of a charitable contribution of a partial interest in property to which paragraph (b) of this section applies is the fair market value of the partial interest at the time of the contribution. See § 1.170A–1(c). The fair market value of such partial interest must be determined in accordance with § 20.2031–7, of this chapter (Estate Tax Regulations), except that, in the case of a charitable contribution of a remainder interest in real property which is not transferred in trust, the fair market value of such interest must be determined in accordance with section 170(f)(4) and § 1.170A–12. In the case of a charitable contribution of a remainder interest in the form of a remainder interest in a pooled income fund, a charitable remainder annuity trust, or a charitable remainder unitrust, the fair market value of the remainder interest must be determined as provided in paragraph (b)(2) of § 1.170A–6. However, in some cases a reduction in the amount of a charitable contribution of the remainder interest may be required. See section 170(e) and paragraph (a) of § 1.170A–4.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. A, an individual owning a 10-story office building, donates the rent-free use of the top floor of the building for the year 1971 to a charitable organization. Since A's contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

Example 2. In 1971, B contributes to a charitable organization an undivided one-half interest in 100 acres of land, whereby as tenants in common they share in the economic benefits from the property. The present value of the contributed property is $50,000. Since B's contribution consists of an undivided portion of his entire interest in the property to which section 170(f)(3)(B) applies, he is allowed a deduction in 1971 for his charitable contribution of $50,000.

Example 3. In 1971, D loans $10,000 in cash to a charitable organization and does not require the organization to pay any interest for the use of the money. Since D's contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

(e) *Effective date.* This section applies only to contributions made after July 31, 1969. The deduction allowable under §1.170A–7(b)(1)(ii) shall be available only for contributions made on or before December 17, 1980. Except as otherwise provided in §1.170A–14(g)(4)(ii), the deduction allowable under §1.170A–7(b)(5) shall be available for contributions made on or after December 18, 1980.

(83 Stat. 544, 26 U.S.C. 170(f)(4); 83 Stat. 560, 26 U.S.C. 642(c)(5); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7207, 37 FR 20782, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8069, 51 FR 1498, Jan. 14, 1986; T.D. 8540, 59 FR 30102, June 10, 1994]

§ 1.170A–8 Limitations on charitable deductions by individuals.

(a) *Percentage limitations*—(1) *In general.* An individual's charitable contributions deduction is subject to 20-, 30-, and 50-percent limitations unless the individual qualifies for the unlimited charitable contributions deduction under section 170(b)(1)(C). For a discussion of these limitations and examples of their application, see paragraphs (b) through (f) of this section. If a husband and wife make a joint return, the deduction for contributions is the aggregate of the contributions made by the spouses, and the limitations in section 170(b) and this section are based on the aggregate contribution base of the spouses. A charitable contribution by an individual to or for the use of an organization described in section 170(c) may be deductible even though all, or some portion, of the funds of the organization may be used in foreign countries for charitable or educational purposes.

(2) *''To'' or ''for the use of'' defined.* For purposes of section 170, a contribution of an income interest in property, whether or not such contributed interest is transferred in trust, for which a deduction is allowed under section 170(f)(2)(B) or (3)(A) shall be considered as made ''for the use of'' rather than ''to'' the charitable organization. A contribution of a remainder interest in property, whether or not such contributed interest is transferred in trust, for which a deduction is allowed under section 170(f)(2)(A) or (3)(A), shall be considered as made ''to'' the charitable organization except that, if such interest is transferred in trust and, pursuant to the terms of the trust instrument, the interest contributed is, upon termination of the predecessor estate, to be held in trust for the benefit of such organization, the contribution shall be considered as made ''for the use of'' such organization. Thus, for example, assume that A transfers property to a charitable remainder annuity trust described in section 664(d)(1) which is required to pay to B for life an annuity equal to 5 percent of the initial fair market value of the property transferred in trust. The trust instrument provides that after B's death the remainder interest in the trust is to be transferred to M Church or, in the event M Church is not an organization described in section 170(c) when the amount is to be irrevocably transferred to such church, to an organization which is described in section 170(c) at that time. The contribution by A of the remainder interest shall be considered as made ''to'' M Church. However, if in the trust instrument A had directed that after B's death the remainder interest is to be held in trust for the benefit of M Church, the contribution shall be considered as made ''for the use of'' M Church. This subparagraph does not apply to the contribution of a partial interest in property, or of an undivided portion of such partial interest, if such partial interest is the donor's entire interest in the property and such entire interest was not created to avoid section 170(f)(2) or (3)(A). See paragraph (a)(2) of §1.170A–6 and paragraphs (a)(2)(i) and (b)(1) of §1.170A–7.

(b) *50-percent limitation.* An individual may deduct charitable contributions made during a taxable year to any one or more section 170(b)(1)(A) organizations, as defined in §1.170A–9, to the extent that such contributions in the aggregate do not exceed 50 percent of his contribution base, as defined in section 170(b)(1)(F) and paragraph (e) of this section, for the taxable year. However, see paragraph (d) of this section for a limitation on the amount of charitable contributions of 30-percent capital gain property. To qualify for the 50-percent limitation the contributions must be made "to," and not merely "for the use of," one of the specified organizations. A contribution to an organization referred to in section 170(c)(2), other than a section 170(b)(1)(A) organization, will not qualify for the 50-percent limitation even though such organization makes the contribution available to an organization which is a section 170 (b)(1)(A) organization. For provisions relating to the carryover of contributions in excess of 50-percent of an individual's contribution base see section 170(d)(1) and paragraph (b) of §1.170A–10.

(c) *20-percent limitation.* (1) An individual may deduct charitable contributions made during a taxable year:

(i) To any one or more charitable organizations described in section 170(c) other than section 170(b)(1)(A) organizations, as defined in §1.170A–9, and,

(ii) For the use of any charitable organization described in section 170(c), to the extent that such contributions in the aggregate do not exceed the lesser of the limitations under subparagraph (2) of this paragraph.

(2) For purposes of subparagraph (1) of this paragraph the limitations are:

(i) 20 percent of the individual's contribution base, as defined in paragraph (e) of this section, for the taxable year, or

(ii) The excess of 50 percent of the individual's contribution base, as so defined, for the taxable year over the total amount of the charitable contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section, determined by first reducing the amount of such contributions under section 170(e)(1) and paragraph (a) of §1.170A–4 but without applying the 30-percent limitation under section 170(b)(1)(D)(i) and paragraph (d)(1) of this section.

However, see paragraph (d) of this section for a limitation on the amount of charitable contributions of 30-percent capital gain property. If an election under section 170(b)(1)(D)(iii) and paragraph (d)(2) of this section applies to any contributions of 30-percent capital gain property made during the taxable year or carried over to the taxable year, the amount allowed for the taxable year under paragraph (b) of this section with respect to such contributions for purposes of applying subdivision (ii) of this subparagraph shall be the reduced amount of such contributions determined by applying paragraph (d)(2) of this section.

(d) *30-percent limitation*—(1) *In general.* An individual may deduct charitable contributions of 30-percent capital gain property, as defined in subparagraph (3) of this paragraph, made during a taxable year to or for the use of any charitable organization described in section 170(c) to the extent that such contributions in the aggregate do not exceed 30-percent of his contribution base, as defined in paragraph (e) of this section, subject, however, to the 50- and 20-percent limitations prescribed by paragraphs (b) and (c) of this section. For purposes of applying the 50-percent and 20-percent limitations described in paragraphs (b) and (c) of this section, charitable contributions of 30-percent capital gain property paid during the taxable year, and limited as provided by this subparagraph, shall be taken into account after all other charitable contributions paid during the taxable year. For provisions relating to the carryover of certain contributions of 30-percent capital gain property in excess of 30-percent of an individual's contribution base, see section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10.

(2) *Election by an individual to have section 170(e)(1)(B) apply to contributions*—(i) *In general.* (A) An individual may elect under section 170(b)(1)(D)(iii) for any taxable year to have the reduction rule of section 170(e)(1)(B) and paragraph (a) of §1.170A–4 apply to all his charitable contributions of 30-percent capital gain property made during such taxable year or carried over to such taxable year from a taxable year beginning after December 31, 1969. If such election is made such contributions shall be treated as contributions of section 170(e) capital gain property in accordance with paragraph (b)(2)(iii) of §1.170A–4. The election may be made with respect to contributions of 30-percent capital gain property carried over to the taxable year even though the individual has not made any contribution of 30-percent capital gain property in such year. If such an election is made,

section 170(b)(1)(D) (i) and (ii) and subparagraph (1) of this paragraph shall not apply to such contributions made during such year. However, such contributions must be reduced as required under section 170(e)(1)(B) and paragraph (a) of §1.170A–4.

(B) If there are carryovers to such taxable year of charitable contributions of 30-percent capital gain property made in preceding taxable years beginning after December 31, 1969, the amount of such contributions in each such preceding year shall be reduced as if section 170(e)(1)(B) had applied to them in the preceding year and shall be carried over to the taxable year and succeeding taxable years under section 170(d)(1) and paragraph (b) of §1.170A–10 as contributions of property other than 30-percent capital gain property. For purposes of applying the immediately preceding sentence, the percentage limitations under section 170(b) for the preceding taxable year and for any taxable years intervening between such year and the year of the election shall not be redetermined and the amount of any deduction allowed for such years under section 170 in respect of the charitable contributions of 30-percent capital gain property in the preceding taxable year shall not be redetermined. However, the amount of the deduction so allowed under section 170 in the preceding taxable year must be subtracted from the reduced amount of the charitable contributions made in such year in order to determine the excess amount which is carried over from such year under section 170(d)(1). If the amount of the deduction so allowed in the preceding taxable year equals or exceeds the reduced amount of the charitable contributions, there shall be no carryover from such year to the year of the election.

(C) An election under this subparagraph may be made for each taxable year in which charitable contributions of 30-percent capital gain property are made or to which they are carried over under section 170(b)(1)(D)(ii). If there are also carryovers under section 170(d)(1) to the year of the election by reason of an election made under this subparagraph for a previous taxable year, such carryovers under section 170(d)(1) shall not be redetermined by reason of the subsequent election.

(ii) *Husband and wife making joint return.* If a husband and wife make a joint return of income for a contribution year and one of the spouses elects under this subparagraph in a later year when he files a separate return, or if a spouse dies after a contribution year for which a joint return is made, any excess contribution of 30-percent capital gain property which is carried over to the election year from the contribution year shall be allocated between the husband and wife as provided in paragraph (d)(4) (i) and (iii) of §1.170A–10. If a husband and wife file separate returns in a contribution year, any election under this subparagraph in a later year when a joint return is filed shall be applicable to any excess contributions of 30-percent capital gain property of either taxpayer carried over from the contribution year to the election year. The immediately preceding sentence shall also apply where two single individuals are subsequently married and file a joint return. A remarried individual who filed a joint return with his former spouse for a contribution year and thereafter files a joint return with his present spouse shall treat the carryover to the election year as provided in paragraph (d)(4)(ii) of §1.170A–10.

(iii) *Manner of making election.* The election under subdivision (i) of this subparagraph shall be made by attaching to the income tax return for the election year a statement indicating that the election under section 170(b)(1)(D)(iii) and this subparagraph is being made. If there is a carryover to the taxable year of any charitable contributions of 30-percent capital gain property from a previous taxable year or years, the statement shall show a recomputation, in accordance with this subparagraph and §1.170A–4, of such carryover, setting forth sufficient information with respect to the previous taxable year or any intervening year to show the basis of the recomputation. The statement shall indicate the district director, or the director of the internal revenue service center, with whom the return for the previous taxable year or years was filed, the name or names in which such return or returns were filed, and whether each such return was a joint or separate return.

(3) *30-percent capital gain property defined.* If there is a charitable contribution of a capital asset which, if it were sold by the donor at its fair market value at the time of its contribution, would result in the recognition of gain all, or any portion, of which would be long-term capital gain and if the amount of such contribution is not required to be reduced under section 170(e)(1)(B) and §1.170A–4(a)(2), such capital asset shall be treated as ''30-percent capital gain property'' for purposes of section 170 and the regulations thereunder. For such purposes any property which is property used in the trade or business, as defined in section 1231(b), shall be treated as a capital asset. However, see paragraph (b)(4) of §1.170A–4. For the treatment of such property as section 170(e) capital gain property, see paragraph (b)(2)(iii) of §1.170A–4.

(e) *Contribution base defined.* For purposes of section 170 the term *contribution base* means adjusted gross income under section 62, computed without regard to any net operating loss carryback to the taxable year under section 172. See section 170(b)(1)(F).

(f) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. B, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). Accordingly, B is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $10,000 ([50% of $100,000]−$40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). Under section 170 (b)(1)(D)(ii) and (d)(1) and §1.170A–10, B is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 2. C, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $40,000 in 30-percent capital gain property to section 170(b)(1)(A) organizations and of $30,000 in cash to other organizations described in section 170(c). The 20-percent limitation in section 170(b)(1)(B) and paragraph (c) of this section is applied before the 30-percent limitation in section 170(b)(1)(D)(i) and paragraph (d) of this section; accordingly section 170(b)(1)(B)(ii) limits the deduction for the $30,000 cash contribution to $10,000 ([50% of $100,000]− $40,000). The amount of the contribution of 30-percent capital gain property is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Accordingly, C's charitable contributions deduction for 1970 is limited to $40,000 ($10,000 + $30,000). Under section 170 (b)(1)(D)(ii) and paragraph (c) of §1.170A–10, C is allowed a carryover to 1971 of $10,000 ($40,000−$30,000) in respect of his contributions of 30-percent capital gain property. C is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 cash ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 3. (a) D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). During 1971 D makes charitable contributions to a section 170(b)(1)(A) organization of $12,000, consisting of cash of $1,000 and $11,000 in 30-percent capital gain property. His contribution base for 1971 is $10,000.

(b) For 1970, D is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $10,000 ([50% of $100,000]−$40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). D is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000−$10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(c) For 1971, D is allowed a charitable contributions deduction of $4,000, consisting of $1,000 cash and $3,000 of the 30-percent capital gain property (30% of $10,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, D is allowed a carryover to 1972 of $8,000

($11,000 − $3,000) in respect of his contribution of 30-percent capital gain property in 1971.

Example 4. (a) E, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000 in cash, of which $40,000 is given to section 170(b)(1)(A) organizations and $30,000 is given to other organizations described in section 170(c). During 1971 E makes charitable contributions to a section 170(b)(1)(A) organization of $14,000 consisting of cash of $3,000 and $11,000 in 30-percent capital gain property. His contribution base for 1971 is $10,000.

(b) For 1970, E is allowed a charitable contributions deduction of $50,000 (50% of $100,000), which consists of the $40,000 contributed to section 170(b)(1)(A) organizations and $10,000 of the $30,000 contributed to the other organizations. Under paragraph (c) of this section, only $10,000 of the $30,000 contributed to the other organizations is allowed as a deduction since such contribution of $30,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or ($10,000 ([50% of $100,000] − $40,000 (contributions allowed under section 170(b)(1)(A) and paragraph (b) of this section)). E is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 ($30,000 − $10,000) not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(c) For 1971, E is allowed a charitable contributions deduction of $5,000 (50% of $10,000), consisting of $3,000 cash and $2,000 of the $3,000 (30% of $10,000) 30-percent capital gain property which is taken into account. This result is reached because, as provided in section 170(b)(1)(D)(i) and paragraph (d)(1) of this section, cash contributions are taken into account before charitable contributions of 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and (d)(1) and paragraphs (b) and (c) of §1.170A–10, E is allowed a carryover of $9,000 ([$11,000 − $3,000] plus [$6,000 − $5,000]) to 1972 in respect of his contribution of 30-percent capital gain property in 1971.

Example 5. In 1970, C, a calendar-year individual taxpayer, contributes to section 170(b)(1)(A) organizations the amount of $8,000, consisting of $3,000 in cash and $5,000 in 30-percent capital gain property. In 1970, C also makes charitable contributions of $8,500 in 30 percent capital gain property to other organizations described in section 170(c). C's contribution base for 1970 is $20,000. The 20-percent limitation in section 170(b)(1)(B) and paragraph (c) of this section is applied before the 30-percent limitation in section 170(b)(1)(D)(i) and paragraph (d) of this section; accordingly, section 170(b)(1)(B)(ii) limits the deduction for the $8,500 of contributions to the other organizations described in section 170(c) to $2,000 ([50% of $20,000] − [$3,000 + $5,000]). However, the total amount of contributions of 30-percent capital gain property which is allowed as a deduction for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $6,000 (30% of $20,000), consisting of the $5,000 contribution to the section 170(b)(1)(A) organizations and $1,000 of the contributions to the other organizations described in section 170(c). Accordingly C is allowed a charitable contributions deduction for 1970 of $9,000, which consists of $3,000 cash and $6,000 of the $13,500 of 30-percent capital gain property. C is not allowed to carryover to 1971 or any other year the remaining $7,500 because his contributions of 30-percent capital gain property for 1970 to section 170(b)(1)(A) organizations amount only to $5,000 and do not exceed $6,000 (30% of $20,000). Thus, the requirement of section 170(b)(1)(D)(ii) is not satisfied.

Example 6. During 1971, D, a calendar-year individual taxpayer, makes a charitable contribution to a church of $8,000, consisting of $5,000 in cash and $3,000 in 30-percent capital gain property. For such year, D's contribution base is $10,000. Accordingly, D is allowed a charitable contributions deduction for 1971 of $5,000 (50% of $10,000) of cash. Under section 170(d)(1) and paragraph (b) of §1.170A–10, D is allowed a carryover to 1972 of his $3,000 contribution of 30-percent capital gain property, even though such amount does not exceed 30 percent of his contribution base for 1971.

Example 7. In 1970, E, a calendar-year individual taxpayer, makes a charitable contribution to a section 170(b)(1)(A) organization in the amount of $10,000, consisting of $8,000 in 30-percent capital gain property and of $2,000 (after reduction under section 170(e)) in other property. E's contribution base of 1970 is $20,000. Accordingly, E is allowed a charitable contributions deduction for 1970 of $8,000, consisting of the $2,000 of property the amount of which was reduced under section 170(e) and $6,000 (30% of $20,000) of the 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10, E is allowed to carryover to 1971 $2,000 ($8,000 − $6,000) of his contribution of 30-percent capital gain property.

Example 8. (a) In 1972, F, calendar-year individual taxpayer, makes a charitable contribution to a church of $4,000, consisting of $1,000 in cash and $3,000 in 30-percent capital gain property. In addition, F makes a charitable contribution in 1972 of $2,000 in cash to an organization described in section 170(c)(4). F also has a carryover from 1971 under section 170(d)(1) of $5,000 (none of which consists of contributions of 30-percent capital gain property) and a carryover from 1971 under section 170(b)(1)(D)(ii) of $6,000 of contributions of 30-percent capital gain property. F's contribution base for 1972 is $11,000.

Accordingly, F is allowed a charitable contributions deduction for 1972 of $5,500 (50% of

$11,000), which consists of $1,000 cash contributed in 1972 to the church, $3,000 of 30-percent capital gain property contributed in 1972 to the church, and $1,500 (carryover of $5,000 but not to exceed [$5,500 − ($1,000 + $3,000)]) of the carryover from 1971 under section 170(d)(1).

(b) No deduction is allowed for 1972 for the contribution in that year of $2,000 cash to the section 170(c)(4) organization since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0([50% of $11,000] − [$1,000 + $1,500 + $3,000]). Moreover, F is not allowed a carryover to 1973 or to any other year for any of such $2,000 cash contributed to the section 170(c)(4) organization.

(c) Under section 170(d)(1) and paragraph (b) of § 1.170A–10, F is allowed a carryover to 1973 from 1971 of $3,500 ($5,000 − $1,500) of contributions of other than 30-percent capital gain property. Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, F is allowed a carryover to 1973 from 1971 of $6,000 ($6,000 − $0 of such carryover treated as paid in 1972) of contributions of 30-percent capital gain property. The portion of such $6,000 carryover from 1971 which is treated as paid in 1972 is $0 ([50% of $11,000] − [$4,000 contributions to the church in 1972 plus $1,500 of section 170(d)(1) carryover treated as paid in 1972]).

Example 9. (a) In 1970, A, a calendar-year individual taxpayer, makes a charitable contribution to a church of 30-percent capital gain property having a fair market value of $60,000 and an adjusted basis of $10,000. A's contribution base for 1970 is $50,000, and he makes no other charitable contributions in that year. A does not elect for 1970 under paragraph (d)(2) of this section to have section 170(e)(1)(B) apply to such contribution. Accordingly, under section 170(b)(1)(D)(i) and paragraph (d) of this section, A is allowed a charitable contributions deduction for 1970 of $15,000 (30% of $50,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, A is allowed a carryover to 1971 of $45,000 ($60,000 − $15,000) for his contribution of 30-percent capital gain property.

(b) In 1971, A makes a charitable contribution to a church of 30-percent capital gain property having a fair market value of $11,000 and an adjusted basis of $10,000. A's contribution base for 1971 is $60,000, and he makes no other charitable contributions in that year. A elects for 1971 under paragraph (d)(2) of this section to have section 170(e)(1)(B) and § 1.170A–4 apply to his contribution of $11,000 in that year and to his carryover of $45,000 from 1970. Accordingly, he is required to recompute his carryover from 1970 as if section 170(e)(1)(B) had applied to his contribution of 30-percent capital gain property in that year.

(c) If section 170(e)(1)(B) had applied in 1970 to his contribution of 30-percent capital gain property, A's contribution would have been reduced from $60,000 to $35,000, the reduction of $25,000 being 50 percent of the gain of $50,000 ($60,000 − $10,000) which would have been recognized as long-term capital gain if the property had been sold by A at its fair market value at the time of the contribution in 1970. Accordingly, by taking the election under paragraph (d)(2) of this section into account, A has a recomputed carryover to 1971 of $20,000 ($35,000 − $15,000) of his contribution of 30-percent capital gain property in 1970. However, A's charitable contributions deduction of $15,000 allowed for 1970 is not recomputed by reason of the election.

(d) Pursuant to the election for 1971, the contribution of 30-percent capital gain property for 1971 is reduced from $11,000 to $10,500, the reduction of $500 being 50 percent of the gain of $1,000 ($11,000 − $10,000) which would have been recognized as long-term capital gain if the property had been sold by A at its fair market value at the time of its contribution in 1971.

(e) Accordingly, A is allowed a charitable contributions deduction for 1971 of $30,000 (total contributions of $30,500 [$20,000 + $10,500] but not to exceed 50% of $60,000).

(f) Under section 170(d)(1) and paragraph (b) of § 1.170A–10, A is allowed a carryover of $500 ($30,500 − $30,000) to 1972 and the 3 succeeding taxable years. The $500 carryover, which by reason of the election is no longer treated as a contribution of 30-percent capital gain property, is treated as carried over under paragraph (b) of § 1.170A–10 from 1970 since in 1971 current year contributions are deducted before contributions which are carried over from preceding taxable years.

Example 10. The facts are the same as in *Example 9* except that A also makes a charitable contribution in 1971 of $2,000 cash to a private foundation not described in section 170(b)(1)(E) and that A's contribution base for that year is $62,000, instead of $60,000. Accordingly, A is allowed a charitable contributions deduction for 1971 of $31,000, determined in the following manner Under section 170(b)(1)(A) and paragraph (b) of this section, A is allowed a charitable contributions deduction for 1971 of $30,500, consisting of $10,500 of property contributed to the church in 1971 and of $20,000 (carryover of $20,000 but not to exceed [($62,000 × 50%) − $10,500]) of contributions of property carried over to 1971 under section 170(d)(1) and paragraph (b) of § 1.170A–10. Under section 170(b)(1)(B) and paragraph (c) of this section, A is allowed a charitable contributions deduction for 1971 of $500 ([50% of $62,000] − [$10,500 + $20,000]) of cash contributed to the private foundation in that year. A is not allowed a carryover to 1972 or to any other taxable year for any of the $1,500 ($2,000 − $500) cash not deductible in 1971 under section 170(b)(1)(B) and paragraph (c) of this section.

Example 11. The facts are the same as in *Example 9* except that A's contribution base for 1970 is $120,000. Thus, before making the election under paragraph (d)(2) of this section for 1971, A is allowed a charitable contributions deduction for 1970 of $36,000 (30% of $120,000) and is allowed a carryover to 1971 of $24,000 ($60,000 − $36,000). By making the election for 1971, A is required to recompute the carryover from 1970, which is reduced from $24,000 to zero, since the charitable contributions deduction of $36,000 allowed for 1970 exceeds the reduced $35,000 contribution for 1970 which iay be taken into account by reason of the election for 1971. Accordingly, A is allowed a deduction for 1971 of $10,500 and is allowed no carryover to 1972, since the reduced contribution for 1971 ($10,500) does not exceed the limitation of $30,000 (50% of $60,000) for 1971 which applies under section 170(d)(1) and paragraph (b) of § 1.170A–10. A's charitable contributions deduction of $36,000 allowed for 1970 is not recomputed by reason of the election. Thus, it is not to A's advantage to make the election under paragraph (d)(2) of this section.

Example 12. (a) B, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes charitable contributions of $70,000, consisting of $50,000 in 30-percent capital gain property contributed to a church and $20,000 in cash contributed to a private foundation not described in section 170(b)(1)(E). For 1971, B's contribution base is $40,000, and in that year he makes a charitable contribution of $5,000 in cash to such private foundation. During the years involved B makes no other charitable contributions.

(b) The amount of the contribution of 30-percent capital gain property which may be taken into account for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Accordingly, under section 170(b)(1)(A) and paragraph (b) of this section B is allowed a deduction for 1970 of $30,000 of 30-percent capital gain property (contribution of $30,000 but not to exceed $50,000 [50% of $100,000]). No deduction is allowed for 1970 for the contribution in that year of $20,000 of cash to the private foundation since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0 ([50% of $100,000] − $50,000, the amount of the contribution of 30-percent capital gain property).

(c) Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, B is allowed a carryover to 1971 of $20,000 ($50,000 − [30% of $100,000]) of his contribution in 1970 of 30-percent capital gain property. B is not allowed a carryover to 1971 or to any other taxable year for any of the $20,000 cash contribution in 1970 which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(d) The amount of the contribution of 30-percent capital gain property which may be taken into account for 1971 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $12,000 (30% of $40,000).

Accordingly, under section 170(b)(1)(A) and paragraph (b) of this section B is allowed a deduction for 1971 of $12,000 of 30-percent capital gain property (contribution of $12,000 but not to exceed $20,000 [50% of $40,000]). No deduction is allowed for 1971 for the contribution in that year of $5,000 of cash to the private foundation, since section 170(b)(1)(B)(ii) and paragraph (c) of this section limit the deduction for such contribution to $0 ([50% of $40,000] − $20,000 carryover of 30-percent capital gain property from 1970).

(e) Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, B is allowed a carryover to 1972 of $8,000 ($20,000 − [30% of $40,000]) of his contribution in 1970 of 30-percent capital gain property. B is not allowed a carryover to 1972 or to any other taxable year for any of the $5,000 cash contribution for 1971 which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 13. D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. On March 1, 1970, he contributes to a church intangible property to which section 1245 applies which has a fair market value of $60,000 and an adjusted basis of $10,000. At the time of the contribution D has used the property in his business for more than 6 months. If the property had been sold by D at its fair market value at the time of its contribution, it is assumed that under section 1245 $20,000 of the gain of $50,000 would have been treated as ordinary income and $30,000 would have been long-term capital gain. Since the property contributed is ordinary income property within the meaning of paragraph (b)(1) of § 1.170A–4, D's contribution of $60,000 is reduced under paragraph (a)(1) of such section to $40,000 ($60,000 − $20,000 ordinary income). However, since the property contributed is also 30-percent capital gain property within the meaning of paragraph (d)(3) of this section, D's deduction for 1970 is limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000). Under section 170(b)(1)(D)(ii) and paragraph (c) of § 1.170A–10, D is allowed to carry over to 1971 $10,000 ($40,000 − $30,000) of his contribution of 30-percent capital gain property.

Example 14. C, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $50,000. During 1970 he makes charitable contributions to a church of $57,000, consisting of $2,000 cash and of 30-percent capital gain property with a fair market value of $55,000 and an adjusted basis of $15,000. In addition, C contributes $3,000 cash in 1970 to a private foundation not described in section 170(b)(1)(E). For 1970, C elects under paragraph (d)(2) of this section to have section 170(e)(1)(B) and §1.170A–4(a) apply to his contribution of property to the church. Accordingly, for 1970 C's contribution of property to the church is reduced from $55,000 to $35,000, the reduction of $20,000 being 50 percent of the gain of $40,000 ($55,000 − $15,000) which would have been recognized as long-term capital gain if the property had been sold by C at its fair market value at the time of its contribution to the church. Under section 170(b)(1)(A) and paragraph (b) of this section, C is allowed a charitable contributions deduction for 1970 of $25,000 ([$2,000 + $35,000] but not to exceed [$50,000 × 50%]). Under section 170(d)(1) and paragraph (b) of §1.170A–10, C is allowed a carryover from 1970 to 1971 of $12,000 ($37,000 − $25,000). No deduction is allowed for 1970 for the contribution in that year of $3,000 cash to the private foundation since section 170(b)(1)(B) and paragraph (c) of this section limit the deduction for such contribution to the smaller of $10,000 ($50,000 × 20%) or $0 ([$50,000 × 50%] − $25,000). C is not allowed a carryover from 1970 for any of the $3,000 cash contribution in that year which is not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

Example 15. (a) D, an individual, reports his income on the calendar-year basis and for 1970 has a contribution base of $100,000. During 1970 he makes a charitable contribution to a church of 30-percent capital gain property with a fair market value of $40,000 and an adjusted basis of $21,000. In addition, he contributes $23,000 cash in 1970 to a private foundation not described in section 170(b)(1)(E). For 1970, D elects under paragraph (d)(2) of this section to have section 170(e)(1)(B) and §1.170A–4(a) apply to his contribution of property to the church. Accordingly, for 1970 D's contribution of property to the church is reduced from $40,000 to $30,500, the reduction of $9,500 being 50 percent of the gain of $19,000 ($40,000 − $21,000) which would have been recognized as long-term capital gain if the property had been sold by D at its fair market value at the time of its contribution to the church. Under section 170(b)(1)(A) and paragraph (b) of this section, D is allowed a charitable contributions deduction for 1970 of $30,500 for the property contributed to the church. In addition, under section 170(b)(1)(B) and paragraph (c) of this section D is allowed a deduction of $19,500 for the cash contributed to the private foundation, since such contribution of $23,000 is allowed to the extent of the lesser of $20,000 (20% of $100,000) or $19,500 ([$100,000 × 50%] − $30,500). D is not allowed a carryover to 1971 or to any other taxable year for any of the $3,500 ($23,000 − $19,500) of cash not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(b) If D had not made the election under paragraph (d)(2) of this section for 1970, his deduction for 1970 under section 170(a) for the $40,000 contribution of property to the church would have been limited by section 170(b)(1)(D)(i) and paragraph (d) of this section to $30,000 (30% of $100,000), and under section 170(b)(1)(D)(ii) and paragraph (c) of §1.170A–10 he would have been allowed a carryover to 1971 of $10,000 ($40,000 − $30,000) for his contribution of such property. In addition, he would have been allowed under section 170(b)(1)(B)(ii) and paragraph (c) of this section for 1970 a charitable contributions deduction of $10,000 ([$100,000 × 50%] − $40,000) for the cash contributed to the private foundation. In such case, D would not have been allowed a carryover to 1971 or to any other taxable year for any of the $13,000 ($23,000 − $10,000) of cash not deductible under section 170(b)(1)(B) and paragraph (c) of this section.

(g) *Effective date*. This section applies only to contributions paid in taxable years beginning after December 31, 1969.

[T.D. 7207, 37 FR 20783, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972]

§ 1.170A–9 Definition of section 170(b)(1)(A) organization.

(a) The term *section 170(b)(1)(A) organization* as used in the regulations under section 170 means any organization described in paragraphs (b) through (j) of this section, effective with respect to taxable years beginning after December 31, 1969, except as otherwise provided. Section 1.170–2(b) shall continue to be applicable with respect to taxable years beginning prior to January 1, 1970. The term *one or more organizations described in section 170(b)(1)(A) (other than clauses (vii) and (viii))* as used in sections 507 and 509 of the Internal Revenue Code (Code) and the regulations means one or more organizations described in paragraphs (b) through (f) of this section, except as modified by the regulations under part II of subchapter F of chapter 1 or under chapter 42.

(b) *Church or a convention or association of churches*. An organization is described in section 170(b)(1)(A)(i) if it is a church or a convention or association of churches.

(c) *Educational organization and organizations for the benefit of certain State and municipal colleges and universities*—(1) *Educational organization*. An educational organization is described in section 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term includes institutions such as primary, secondary, preparatory, or high schools, and colleges and universities. It includes Federal, State, and other public-supported schools which otherwise come within the definition. It does not include organizations engaged in both educational and noneducational activities unless the latter are merely incidental to the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization within the meaning of section 170(b)(1)(A)(ii). However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization within the meaning of this subparagraph.

(2) *Organizations for the benefit of certain State and municipal colleges and universities.* (i) An organization is described in section 170(b)(1)(A)(iv) if it meets the support requirements of subdivision (ii) of this subparagraph and is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization described in subdivision (iii) of this subparagraph. The phrase ''expenditures to or for the benefit of a college or university'' includes expenditures made for any one or more of the normal functions of colleges and universities such as the acquisition and maintenance of real property comprising part of the campus area; the erection of, or participation in the erection of, college or university buildings; the acquisition and maintenance of equipment and furnishings used for, or in conjunction with, normal functions of colleges and universities; or expenditures for scholarships, libraries and student loans.

(ii) To qualify under section 170(b)(1)(A)(iv), the organization receiving the contribution must normally receive a substantial part of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, or from a combination of two or more of such sources. For such purposes, the term ''support'' does not include income received in the exercise or performance by the organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). An example of an indirect contribution from the public is the receipt by the organization of its share of the proceeds of an annual collection campaign of a community chest, community fund, or united fund. In determining the amount of support received by such organization with respect to a contribution of property which is subject to reduction under section 170(e), the fair market value of the property shall be taken into account.

(iii) The college or university (including a land grant college or university) to be benefited must be an educational organization referred to in section 170(b)(1)(A)(ii) and subparagraph (1) of this paragraph which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions.

(d) *Hospitals and medical research organizations*—(1) *Hospitals.* An organization (other than one described in paragraph (d)(2) of this section) is described in section 170(b)(1)(A)(iii) if—

(i) It is a hospital; and

(ii) Its principal purpose or function is the providing of medical or hospital care or medical education or medical research.

(A) The term *hospital* includes—

(*1*) Federal hospitals; and

(*2*) State, county, and municipal hospitals which are instrumentalities of governmental units referred to in section 170(c)(1) and otherwise come within the definition. A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a ''hospital'' within the meaning of paragraph (d)(1)(i) of this section if its principal purpose or function is the providing of hospital or medical care. For purposes of this paragraph (d)(1)(ii), the term *medical care* shall include the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under section 213 by the person treated. An organization, all the accommodations of which qualify as being part of a "skilled nursing facility" within the meaning of 42 U.S.C. 1395x(j), may qualify as a "hospital" within the meaning of paragraph (d)(1)(i) of this section if its principal purpose or function is the providing of hospital or medical care. For taxable years ending after June 28, 1968, the term *hospital* also includes cooperative hospital service organizations which meet the requirements of section 501(e) and § 1.501(e)–1.

(B) The term *hospital* does not, however, include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purpose or function is to train handicapped individuals to pursue some vocation. An organization whose principal purpose or function is the providing of medical education or medical research will not be considered a "hospital" within the meaning of paragraph (d)(1)(i) of this section, unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an inpatient or outpatient basis, as an integral part of its medical education or medical research functions. See, however, paragraph (d)(2) of this section with respect to certain medical research organizations.

(2) *Certain medical research organizations*—(i) *Introduction.* A medical research organization is described in section 170(b)(1)(A)(iii) if the principal purpose or functions of such organization are medical research and if it is directly engaged in the continuous active conduct of medical research in conjunction with a hospital. In addition, for purposes of the 50 percent limitation of section 170(b)(1)(A) with respect to a contribution, during the calendar year in which the contribution is made such organization must be committed to spend such contribution for such research before January 1 of the fifth calendar year which begins after the date such contribution is made. An organization need not receive contributions deductible under section 170 to qualify as a medical research organization and such organization need not be committed to spend amounts to which the limitation of section 170(b)(1)(A) does not apply within the 5-year period referred to in this paragraph (d)(2)(i). However, the requirement of continuous active conduct of medical research indicates that the type of organization contemplated in this paragraph (d)(2) is one which is primarily engaged directly in the continuous active conduct of medical research, as compared to an inactive medical research organization or an organization primarily engaged in funding the programs of other medical research organizations. As in the case of a hospital, since an organization is ordinarily not described in section 170(b)(1)(A)(iii) as a hospital unless it functions primarily as a hospital, similarly a medical research organization is not so described unless it is primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital. Accordingly, the rules of this paragraph (d)(2) shall only apply with respect to such medical research organizations.

(ii) *General rule.* An organization (other than a hospital described in paragraph (d)(1) of this section) is described in section 170(b)(1)(A)(iii) only if within the meaning of this paragraph (d)(2):

(A) The principal purpose or functions of such organization are to engage primarily in the conduct of medical research; and

(B) It is primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital which is—

(*1*) Described in section 501(c)(3);

(*2*) A Federal hospital; or

(*3*) An instrumentality of a governmental unit referred to in section 170(c)(1).

(C) In order for a contribution to such organization to qualify for purposes of the 50 percent limitation of section 170(b)(1)(A), during the calendar year in which such contribution is made or treated as made, such organization must be committed (within the meaning of paragraph (d)(2)(viii) of this section) to spend such contribution for such active conduct of medical research before January 1 of the fifth calendar year beginning after the date such contribution is made. For the meaning of the term ''medical research'' see paragraph (d)(2)(iii) of this section. For the meaning of the term ''principal purpose or functions'' see paragraph (d)(2)(iv) of this section. For the meaning of the term ''primarily engaged directly in the continuous active conduct of medical research'' see paragraph (d)(2)(v) of this section. For the meaning of the term ''medical research in conjunction with a hospital'' see paragraph (d)(2)(vii) of this section.

(iii) *Definition of medical research. Medical research* means the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of man. To qualify as a medical research organization, the organization must have or must have continuously available for its regular use the appropriate equipment and professional personnel necessary to carry out its principal function. Medical research encompasses the associated disciplines spanning the biological, social and behavioral sciences. Such disciplines include chemistry (biochemistry, physical chemistry, bioorganic chemistry, etc.), behavioral sciences (psychiatry, physiological psychology, neurophysiology, neurology, neurobiology, and social psychology, etc.), biomedical engineering (applied biophysics, medical physics, and medical electronics, for example, developing pacemakers and other medically related electrical equipment), virology, immunology, biophysics, cell biology, molecular biology, pharmacology, toxicology, genetics, pathology, physiology, microbiology, parasitology, endocrinology, bacteriology, and epidemiology.

(iv) *Principal purpose or functions.* An organization must be organized for the principal purpose of engaging primarily in the conduct of medical research in order to be an organization meeting the requirements of this paragraph (d)(2). An organization will normally be considered to be so organized if it is expressly organized for the purpose of conducting medical research and is actually engaged primarily in the conduct of medical research. Other facts and circumstances, however, may indicate that an organization does not meet the principal purpose requirement of this paragraph (d)(2)(iv) even where its governing instrument so expressly provides. An organization that otherwise meets all of the requirements of this paragraph (d)(2) (including this paragraph (d)(2)(iv)) to qualify as a medical research organization will not fail to so qualify solely because its governing instrument does not specifically state that its principal purpose is to conduct medical research.

(v) *Primarily engaged directly in the continuous active conduct of medical research*—(A) In order for an organization to be primarily engaged directly in the continuous active conduct of medical research, the organization must either devote a substantial part of its assets to, or expend a significant percentage of its endowment for, such purposes, or both. Whether an organization devotes a substantial part of its assets to, or makes significant expenditures for, such continuous active conduct depends upon the facts and circumstances existing in each specific case. An organization will be treated as devoting a substantial part of its assets to, or expending a significant percentage of its endowment for, such purposes if it meets the appropriate test contained in paragraph (d)(2)(v)(B) of this section. If an organization fails to satisfy both of such tests, in evaluating the facts and circumstances, the factor given most weight is the margin by which the organization failed to meet such tests. Some of the other facts and circumstances to be considered in making such a determination are—

(*1*) If the organization fails to satisfy the tests because it failed to properly value its assets or endowment, then upon determination of the improper valuation it devotes additional assets to, or makes additional expenditures for, such purposes, so that it satisfies such tests on an aggregate basis for the prior year in addition to such tests for the current year;

(*2*) The organization acquires new assets or has a significant increase in the value of its securities after it had developed a budget in a prior year based on the assets then owned and the then current values;

(*3*) The organization fails to make expenditures in any given year because of the interrelated aspects of its budget and long-term planning requirements, for example, where an organization prematurely terminates an unsuccessful program and because of long-term planning requirements it will not be able to establish a fully operational replacement program immediately; and

(*4*) The organization has as its objective to spend less than a significant percentage in a particular year but make up the difference in the subsequent few years, or to budget a greater percentage in an earlier year and a lower percentage in a later year.

(B) For purposes of this section, an organization which devotes more than one half of its assets to the continuous active conduct of medical research will be considered to be devoting a substantial part of its assets to such conduct within the meaning of paragraph (d)(2)(v)(A) of this section. An organization which expends funds equaling 3.5 percent or more of the fair market value of its endowment for the continuous active conduct of medical research will be considered to have expended a significant percentage of its endowment for such purposes within the meaning of paragraph (d)(2)(v)(A) of this section.

(C) Engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others. Therefore, if an organization's primary purpose is to disburse funds to other organizations for the conduct of research by them or to extend grants or scholarships to others, it is not primarily engaged directly in the continuous active conduct of medical research.

(vi) *Special rules.* The following rules shall apply in determining whether a substantial part of an organization's assets are devoted to, or its endowment is expended for, the continuous active conduct of medical research activities:

(A) An organization may satisfy the tests of paragraph (d)(2)(v)(B) of this section by meeting such tests either for a computation period consisting of the immediately preceding taxable year, or for the computation period consisting of the immediately preceding four taxable years. In addition, for taxable years beginning in 1970, 1971, 1972, 1973, and 1974, if an organization meets such tests for the computation period consisting of the first four taxable years beginning after December 31, 1969, an organization will be treated as meeting such tests, not only for the taxable year beginning in 1974, but also for the preceding four taxable years. Thus, for example, if a calendar year organization failed to satisfy such tests for a computation period consisting of 1969, 1970, 1971, and 1972, but on the basis of a computation period consisting of the years 1970 through 1973, it expended funds equaling 3.5 percent or more of the fair market value of its endowment for the continuous active conduct of medical research, such organization will be considered to have expended a significant percentage of its endowment for such purposes for the taxable years 1970 through 1974. In applying such tests for a four-year computation period, although the organization's expenditures for the entire four-year period shall be aggregated, the fair market value of its endowment for each year shall be summed, even though, in the case of an asset held throughout the four-year period, the fair market value of such an asset will be counted four times. Similarly, the fair market value of an organization's assets for each year of a four-year computation period shall be summed.

(B) Any property substantially all the use of which is ''substantially related'' (within the meaning of section 514(b)(1)(A)) to the exercise or performance of the organization's medical research activities will not be treated as part of its endowment.

(C) The valuation of assets must be made with commonly accepted methods of valuation. A method of valuation made in accordance with the principles stated in the regulations under section 2031 constitutes an acceptable method of valuation. Assets may be valued as of any day in the organization's taxable year to which such valuation applies, provided the organization follows a consistent practice of valuing such asset as of such date in all taxable years. For purposes of paragraph (d)(2)(v) of this section, an asset held by the organization for part of a taxable year shall be taken into account by multiplying the fair market value of such asset by a fraction, the numerator of which is the number of days in such taxable year that the organization held such asset and the denominator of which is the number of days in such taxable year.

(vii) *Medical research in conjunction with a hospital.* The organization need not be formally affiliated with a hospital to be considered primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital, but in any event there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations will maintain continuing close cooperation in the active conduct of medical research. For example, the necessary joint effort will normally be found to exist if the activities of the medical research organization are carried on in space located within or adjacent to a hospital, the organization is permitted to utilize the facilities (including equipment, case studies, etc.) of the hospital on a continuing basis directly in the active conduct of medical research, and there is substantial evidence of the close cooperation of the members of the staff of the research organization and members of the staff of the particular hospital or hospitals. The active participation in medical research by members of the staff of the particular hospital or hospitals will be considered to be evidence of such close cooperation. Because medical research may involve substantial investigation, experimentation and study not immediately connected with hospital or medical care, the requisite joint effort will also normally be found to exist if there is an established relationship between the research organization and the hospital which provides that the cooperation of appropriate personnel and the use of facilities of the particular hospital or hospitals will be required whenever it would aid such research.

(viii) *Commitment to spend contributions.* The organization's commitment that the contribution will be spent within the prescribed time only for the prescribed purposes must be legally enforceable. A promise in writing to the donor in consideration of his making a contribution that such contribution will be so spent within the prescribed time will constitute a commitment. The expenditure of contributions received for plant, facilities, or equipment, used solely for medical research purposes (within the meaning of paragraph (d)(2)(ii) of this section), shall ordinarily be considered to be an expenditure for medical research. If a contribution is made in other than money, it shall be considered spent for medical research if the funds from the proceeds of a disposition thereof are spent by the organization within the five-year period for medical research; or, if such property is of such a kind that it is used on a continuing basis directly in connection with such research, it shall be considered spent for medical research in the year in which it is first so used. A medical research organization will be presumed to have made the commitment required under this paragraph (d)(2)(viii) with respect to any contribution if its governing instrument or by-laws require that every contribution be spent for medical research before January 1 of the fifth year which begins after the date such contribution is made.

(ix) *Organizational period for new organizations.* A newly created organization, for its ''organizational'' period, shall be considered to be primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital within the meaning of paragraphs (d)(2)(v) and (d)(2)(vii) of this section if during such period the organization establishes to the satisfaction of the Commissioner that it reasonably can be expected to be so engaged by the end of such period. The information to be submitted shall include detailed plans showing the proposed initial medical research program, architectural drawings for the erection of buildings and facilities to be used for medical research in accordance with such plans, plans to assemble a professional staff and detailed projections showing the timetable for the expected accomplishment of the foregoing. The ''organizational'' period shall be that period which is appropriate to implement the proposed plans, giving effect to the proposed amounts involved and the magnitude and complexity of the projected medical research program, but in no event in excess of three years following organization.

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

Example 1. N, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. All of N's assets were contributed to it by A and consist of a diversified portfolio of stocks and bonds. N's endowment earns 3.5 percent annually, which N expends in the conduct of various medical research programs in conjunction with Y hospital. N is located adjacent to Y hospital, makes substantial use of Y's facilities, and there is close cooperation between the staffs of N and Y. N is directly engaged in the continuous active conduct of medical research in conjunction with a hospital, meets the principal purpose test described in paragraph (d)(2)(iv) of this section, and is therefore an organization described in section 170(b)(1)(A)(iii).

Example 2. O, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. All of O's assets consist of a diversified portfolio of stocks and bonds. O's endowment earns 3.5 percent annually, which O expends in the conduct of various medical research programs in conjunction with certain hospitals. However, in 1974, O receives a substantial bequest of additional stocks and bonds. O's budget for 1974 does not take into account the bequest and as a result O expends only 3.1 percent of its endowment in 1974. However, O establishes that it will expend at least 3.5 percent of its endowment for the active conduct of medical research for taxable years 1975 through 1978. O is therefore directly engaged in the continuous active conduct of medical research in conjunction with a hospital for taxable year 1975. Since O also meets the principal purpose test described in paragraph (d)(2)(iv) of this section, it is therefore an organization described in section 170(b)(1)(A)(iii) for taxable year 1975.

Example 3. M, an organization referred to in section 170(c)(2), was created to promote human knowledge within the field of medical research and medical education. M's activities consist of the conduct of medical research programs in conjunction with various hospitals. Under such programs, researchers employed by M engage in research at laboratories set aside for M within the various hospitals. Substantially all of M's assets consist of 100 percent of the stock of X corporation, which has a fair market value of approximately 100 million dollars. X pays M approximately 3.3 million dollars in dividends annually, which M expends in the conduct of its medical research programs. Since M expends only 3.3 percent of its endowment, which does not constitute a significant percentage, in the active conduct of medical research, M is not an organization described in section 170(b)(1)(A)(iii) because M is not engaged in the continuous active conduct of medical research.

(xi) *Special rule for organizations with existing ruling.* This paragraph (d)(2)(xi) shall apply to an organization that prior to January 1, 1970, had received a ruling or determination letter which has not been expressly revoked holding the organization to be a medical research organization described in section 170(b)(1)(A)(iii) and with respect to which the facts and circumstances on which the ruling was based have not substantially changed. An organization to which this paragraph (d)(2)(xi) applies shall be treated as an organization described in section 170(b)(1)(A)(iii) for a period not ending prior to 90 days after February 13, 1976 (or where appropriate, for taxable years beginning before such 90th day). In addition, with respect to a grantor or contributor under sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, the status of an organization to which this paragraph (d)(2)(xi) applies will not be affected until notice of change of status under section 170(b)(1)(A)(iii) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply if the grantor or contributor had previously acquired knowledge that the Internal Revenue Service had given notice to such organization that it would be deleted from classification as a section 170(b)(1)(A)(iii) organization.

(e) *Governmental unit.* A governmental unit is described in section 170(b)(1)(A)(v) if it is referred to in section 170(c)(1).

(f) *Definition of section 170(b)(1)(A)(vi) organization*—(1) *In general.* An organization is described in section 170(b)(1)(A)(vi) if it—

(i) Is referred to in section 170(c)(2) (other than an organization specifically described in paragraphs (b) through (e) of this section); and

(ii) Normally receives a substantial part of its support from a governmental unit referred to in section 170(c)(1) or from direct or indirect contributions from the general public (''publicly supported''). For purposes of this paragraph (f), an organization is publicly supported if it meets the requirements of either paragraph (f)(2) of this section (33⅓ percent support test) or paragraph (f)(3) of this section (facts and circumstances test). Paragraph (f)(4) of this section defines ''normally'' for purposes of the 33⅓ percent support test and the facts and circumstances test, and for new organizations in the first five years of the organization's existence as a section 501(c)(3) organization. Paragraph (f)(5) of this section provides for determinations of foundation classification and rules for reliance by donors and contributors. Paragraphs (f)(6), (f)(7), and (f)(8) of this section list the items that are included and excluded from the term support. Paragraph (f)(9) of this section provides examples of the application of this paragraph. Types of organizations that, subject to the provisions of this paragraph (f), generally qualify under section 170(b)(1)(A)(vi) as ''publicly supported'' are publicly or governmentally supported museums of history, art, or science, libraries, community centers to promote the arts, organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama or for some other direct service to the general public.

(2) *Determination whether an organization is ''publicly supported''; 33⅓ percent support test.* An organization is publicly supported if the total amount of support (see paragraphs (f)(6), (f)(7), and (f)(8) of this section) that the organization normally (see paragraph (f)(4)(i) of this section) receives from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources, equals at least 33⅓ percent of the total support normally received by the organization. See paragraph (f)(9), *Example 1* of this section.

(3) *Determination whether an organization is ''publicly supported''; facts and circumstances test.* Even if an organization fails to meet the 33⅓ percent support test described in paragraph (f)(2) of this section, it is publicly supported if it normally (see paragraph (f)(4)(i) of this section) receives a substantial part of its support from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources, and meets the other requirements of this paragraph (f)(3). In order to satisfy the facts and circumstances test, an organization must meet the requirements of paragraphs (f)(3)(i) and (f)(3)(ii) of this section. In addition, the organization must be in the nature of an organization that is publicly supported, taking into account all pertinent facts and circumstances, including the factors listed in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(E) of this section.

(i) *Ten-percent support limitation.* The percentage of support (see paragraphs (f)(6), (f)(7) and (f)(8) of this section) normally received by an organization from governmental units, from contributions made directly or indirectly by the general public, or from a combination of these sources, must be substantial. For purposes of this paragraph (f)(3), an organization will not be treated as normally receiving a substantial amount of governmental or public support unless the total amount of governmental and public support normally received equals at least 10 percent of the total support normally received by such organization.

(ii) *Attraction of public support.* An organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis. An organization will be considered to meet this requirement if it maintains a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved, or if it carries on activities designed to attract support from governmental units or other organizations described in section 170(b)(1)(A)(i) through (b)(1)(A)(vi). In determining whether an organization maintains a continuous and bona fide program for solicitation of funds from the general public or community, consideration will be given to whether the scope of its fundraising activities is reasonable in light of its charitable activities. Consideration will also be given to the fact that an organization, in its early years of existence, may limit the scope of its solicitation to persons deemed most likely to provide seed money in an amount sufficient to enable it to commence its charitable activities and expand its solicitation program.

(iii) In addition to the requirements set forth in paragraphs (f)(3)(i) and (f)(3)(ii) of this section that must be satisfied, all pertinent facts and circumstances, including the following factors, will be taken into consideration in determining whether an organization is ''publicly supported'' within the meaning of paragraph (f)(1) of this section. However, an organization is not generally required to satisfy all of the factors in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(E) of this section. The factors relevant to each case and the weight accorded to any one of them may differ depending upon the nature and purpose of the organization and the length of time it has been in existence.

(A) *Percentage of financial support.* The percentage of support received by an organization from public or governmental sources will be taken into consideration in determining whether an organization is ''publicly supported.'' The higher the percentage of support above the 10 percent requirement of paragraph (f)(3)(i) of this section from public or governmental sources, the lesser will be the burden of establishing the publicly supported nature of the organization through other factors, including those described in this paragraph (f)(3), while the lower the percentage, the greater will be the burden. If the percentage of the organization's support from public or governmental sources is low because it receives a high percentage of its total support from investment income on its endowment funds, such fact will be treated as evidence of an organization being ''publicly supported'' if such endowment funds were originally contributed by a governmental unit or by the general public. However, if such endowment funds were originally contributed by a few individuals or members of their families, such fact will increase the burden on the organization of establishing that it is ''publicly supported'' taking into account all pertinent facts and circumstances, including the other factors described in paragraph (f)(3)(iii) of this section.

(B) *Sources of support.* The fact that an organization meets the requirement of paragraph (f)(3)(i) of this section through support from governmental units or directly or indirectly from a representative number of persons, rather than receiving almost all of its support from the members of a single family, will be considered evidence of an organization being ''publicly supported.'' In determining what is a ''representative number of persons,'' consideration will be given to the type of organization involved, the length of time it has been in existence, and whether it limits its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons.

(C) *Representative governing body.* The fact that an organization has a governing body which represents the broad interests of the public, rather than the personal or private interests of a limited number of donors (or persons standing in a relationship to such donors which is described in section 4946(a)(1)(C) through (a)(1)(G)), will be considered evidence of an organization being ''publicly supported.'' An organization will be treated as having a representative governing body if it has a governing body (whether designated in the organization's governing instrument or bylaws as a Board of Directors, Board of Trustees, or similar governing body) which is comprised of public officials acting in their capacities as such; of individuals selected by public officials acting in their capacities as such; of persons having special knowledge or expertise in the particular field or discipline in which the organization is operating; of community leaders, such as elected or appointed officials, clergymen, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community; or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership.

(D) *Availability of public facilities or services; public participation in programs or policies.* (*1*) The fact that an organization generally provides facilities or services directly for the benefit of the general public on a continuing basis (such as a museum or library which holds open its building or facilities to the public, a symphony orchestra which gives public performances, a conservation organization which provides educational services to the public through the distribution of educational materials, or an old age home which provides domiciliary or nursing services for members of the general public) will be considered evidence that such organization is ''publicly supported.''

(*2*) The fact that an organization is an educational or research institution which regularly publishes scholarly studies that are widely used by colleges and universities or by members of the general public will also be considered evidence that such organization is ''publicly supported.''

(*3*) The following factors will also be considered evidence that an organization is ''publicly supported'':

(*i*) The participation in, or sponsorship of, the programs of the organization by members of the public having special knowledge or expertise, public officials, or civic or community leaders.

(*ii*) The maintenance of a definitive program by an organization to accomplish its charitable work in the community, such as combating community deterioration in an economically depressed area that has suffered a major loss of population and jobs.

(*iii*) The receipt of a significant part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant, contract, or contribution.

(E) *Additional factors pertinent to membership organizations.* The following are additional factors to be considered in determining whether a membership organization is ''publicly supported'':

(*1*) Whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community or area, or in a particular profession or field of special interest (taking into account the size of the area and the nature of the organization's activities).

(*2*) Whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross section of the interested public, rather than to restrict membership to a limited number of persons.

(*3*) Whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations. See *Example 2* through *Example 5* contained in paragraph (f)(9) of this section for illustrations of this paragraph (f)(3).

(4) *Definition of normally; general rule*—(i) *Normally; 33⅓ percent support test.* An organization ''normally'' receives the requisite amount of public support and meets the 33⅓ percent support test for a taxable year and the taxable year immediately succeeding that year, if, for the taxable year being tested and the four taxable years immediately preceding that taxable year, the organization meets the 33⅓ percent support test on an aggregate basis.

(ii) *Normally; facts and circumstances test.* An organization ''normally'' receives the requisite amount of public support and meets the facts and circumstances test of paragraph (f)(3) for a taxable year and the taxable year immediately succeeding that year, if, for the taxable year being tested and the four taxable years immediately preceding that taxable year, the organization meets the facts and circumstances test on an aggregate basis. In the case of paragraphs (f)(3)(iii)(A) and (f)(3)(iii)(B) of this section, facts pertinent to years preceding the five-year period may also be taken into consideration. The combination of factors set forth in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(E) of this section that an organization normally must meet does not have to be the same for each five-year period so long as there exists a sufficient combination of factors to show compliance with the facts and circumstances test.

(iii) *Special rule.* The fact that an organization has normally met the requirements of the 33⅓ percent support test for a current taxable year, but is unable normally to meet such requirements for a succeeding taxable year, will not in itself prevent such organization from meeting the facts and circumstances test for such succeeding taxable year.

(iv) *Example.* The application of paragraphs (f)(4)(i), (f)(4)(ii), and (f)(4)(iii) of this section may be illustrated by the following example:

Example. (i) X is recognized as an organization described in section 501(c)(3). On the basis of support received during taxable years 2008, 2009, 2010, 2011, and 2012, in the aggregate, X receives at least 33⅓ percent of its support from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources. Consequently, X meets the 33⅓ percent support test for taxable year 2012 (the current taxable year). X also meets the 33⅓ support test for 2013, as the immediately succeeding taxable year.

(ii) In taxable years 2009, 2010, 2011, 2012, and 2013, in the aggregate, X does not receive at least 33⅓ percent of its support from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources. However, X still meets the 33⅓ percent support test for taxable year 2013 based on the aggregate support received for taxable years 2008 through 2012.

(iii) In taxable years 2010, 2011, 2012, 2013, and 2014, in the aggregate, X does not receive at least 33⅓ percent of its support from governmental units referred to in section 170(c)(1), from contributions made directly or indirectly by the general public, or from a combination of these sources. X does not meet the 33⅓ percent support test for taxable year 2014.

(iv) X meets the facts and circumstances test for taxable year 2013 and for taxable year 2014 (the immediately succeeding taxable year) based on the aggregate support X receives, X's fundraising program, and consideration of other factors, including those listed in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(E) of this section, during taxable years 2009, 2010, 2011, 2012, and 2013. Therefore, even though X does not meet the 33⅓ percent support test for taxable year 2014, X is still an organization described in section 170(b)(1)(A)(vi) for that year.

(v) *Normally; first five years of an organization's existence.* (A) An organization ''normally'' receives the requisite amount of public support and meets the 33⅓ percent public support test or the facts and circumstances test during its first five taxable years as a section 501(c)(3) organization if the organization can reasonably be expected to meet the requirements of the 33⅓ percent support test or the facts and circumstances test during that period. With respect to such organization's sixth taxable year, the general definition of normally set forth in paragraphs (f)(4)(i), (f)(4)(ii), and (f)(4)(iii) of this section apply. Alternatively, the organization shall be treated as ''normally'' meeting the 33⅓ percent support test or the facts and circumstances test for its sixth taxable year (but not its seventh taxable year) if it meets the 33⅓ percent support test or the facts and circumstances test under the definition of normally set forth in paragraphs (f)(4)(i), (f)(4)(ii), and (f)(4)(iii) of this section for its fifth taxable year (based on support received in its first through fifth taxable years).

(B) *Basic consideration.* In determining whether an organization can reasonably be expected (within the meaning of paragraph (f)(4)(v)(A) of this section) to meet the requirements of the 33⅓ percent support test or the facts and circumstances test during its first five taxable years, the basic consideration is whether its organizational structure, current or proposed programs or activities, and actual or intended method of operation are such as can reasonably be expected to attract the type of broadly based support from the general public, public charities, and governmental units that is necessary to meet such tests. The factors that are relevant to this determination, and the weight accorded to each of them, may differ from case to case, depending on the nature and functions of the organization. The information to be considered for this purpose shall consist of all pertinent facts and circumstances, including the factors set forth in paragraph (f)(3) of this section.

(vi) *Example*. The application of paragraph (f)(4)(v) of this section may be illustrated by the following example:

Example. (i) Organization Y was formed in January 2008, and uses a taxable year ending December 31. After September 9, 2008, and before December 31, 2008, Organization Y filed Form 1023 requesting recognition of exemption as an organization described in section 501(c)(3) and in sections 170(b)(1)(A)(vi) and 509(a)(1). In its application, Organization Y established that it can reasonably be expected to operate as a publicly supported organization under paragraph (f)(2) or (f)(3) and paragraph (f)(4)(v) of this section. Subsequently, Organization Y received a ruling or determination letter that it is an organization described in section 501(c)(3) and sections 170(b)(1)(A)(vi) and 509(a)(1) effective as of the date of its formation.

(ii) Organization Y is described in sections 170(b)(1)(A)(vi) and 509(a)(1) for its first five taxable years (the taxable years ending December 31, 2008, through December 31, 2012).

(iii) Organization Y can qualify as a publicly supported organization for the taxable year ending December 31, 2013, if Organization Y can meet the requirements of either paragraph (f)(2) or paragraph (f)(3) of this section or §1.509(a)–3(a) and §1.509(a)–(3)(b) for the taxable years ending December 31, 2009, through December 31, 2013, or for the taxable years ending December 31, 2008, through December 31, 2012.

(vii) *Organizations reclassified as private foundations*. (A) *New publicly supported organizations*. If a new publicly supported organization described under section 170(b)(1)(A)(vi) cannot meet the requirements of the 33⅓ percent test of paragraph (f)(2) or the facts and circumstances test of paragraph (f)(3) for its sixth taxable year under the general definition of normally set forth in paragraphs (f)(4)(i), (f)(4)(ii), and (f)(4)(iii) of this section or under the alternate rule set forth in paragraph (f)(4)(v) of this section (effectively failing to meet a public support test for both its fifth and sixth taxable years), it will be treated as a private foundation as of the first day of its sixth taxable year only for purposes of sections 507, 4940, and 6033. Such an organization must file a Form 990–PF, ''Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation,'' and will be liable for the net investment tax imposed by section 4940 and, if applicable, the private foundation termination tax imposed by section 507(c), for its sixth taxable year. For succeeding taxable years, the organization will be treated as a private foundation for all purposes.

(B) *Other publicly supported organizations*. A publicly supported organization described in section 170(b)(1)(A)(vi) (other than a new publicly supported organization described in paragraph (f)(4)(vii)(A) of this section) that has failed to meet both the 33⅓ percent support test and the facts and circumstances test for any two consecutive taxable years will be treated as a private foundation as of the first day of the second consecutive taxable year only for purposes of sections 507, 4940, and 6033. Such an organization must file a Form 990–PF, ''Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation,'' and will be liable for the net investment tax imposed by section 4940 and, if applicable, the private foundation termination tax imposed by section 507(c), for the second consecutive failed taxable year. For succeeding taxable years, the organization will be treated as a private foundation for all purposes.

(5) *Determinations of foundation classification and reliance*. (i) A ruling or determination letter that an organization is described in section 170(b)(1)(A)(vi) may be issued to an organization. Such determination may be made in conjunction with the recognition of the organization's tax-exempt status or at such other time as the organization believes it is described in section 170(b)(1)(A)(vi). The ruling or determination letter that the organization is described in section 170(b)(1)(A)(vi) may be revoked if, upon examination, the organization has not met the requirements of paragraph (f) of this section. The ruling or determination letter that the organization is described in section 170(b)(1)(A)(vi) also may be revoked if the organization's application for a ruling or determination contained one or more material misstatements or omissions of fact or if such application was part of a scheme or plan to avoid or evade any provision of the Internal Revenue Code. The revocation of the determination that an organization is described in

section 170(b)(1)(A)(vi) does not preclude revocation of the determination that the organization is described in section 501(c)(3).

(ii) *Status of grantors or contributors.* For purposes of sections 170, 507, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522, grantors or contributors may rely upon a determination letter or ruling that an organization is described in section 170(b)(1)(A)(vi) until the IRS publishes notice of a change of status (for example, in the Internal Revenue Bulletin or Publication 78, ''Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986,'' which can be searched at *http://www.irs.gov.*) For this purpose, grantors or contributors also may rely on an advance ruling that expires on or after June 9, 2008. However, a grantor or contributor may not rely on such an advance ruling or any determination letter or ruling if the grantor or contributor was responsible for, or aware of, the act or failure to act that resulted in the organization's loss of classification under section 170(b)(1)(A)(vi) or acquired knowledge that the IRS had given notice to such organization that it would be deleted from such classification.

(iii) *Reliance by grantors or contributors.* A grantor or contributor, other than one of the organization's founders, creators, or foundation managers (within the meaning of section 4946(b)), will not be considered to be responsible for, or aware of, the act or failure to act that resulted in the loss of the organization's ''publicly supported'' classification under section 170(b)(1)(A)(vi), if such grantor or contributor has made such grant or contribution in reliance upon a written statement by the grantee organization that such grant or contribution will not result in the loss of such organization's classification as a publicly supported organization as described in section 170(b)(1)(A)(vi). Such statement must be signed by a responsible officer of the grantee organization and must set forth sufficient information, including a summary of the pertinent financial data for the five taxable years immediately preceding the current taxable year, to assure a reasonably prudent person that his grant or contribution will not result in the loss of the grantee organization's classification as a publicly supported organization as described in section 170(b)(1)(A)(vi). If a reasonable doubt exists as to the effect of such grant or contribution, or if the grantor or contributor is one of the organization's founders, creators, or foundation managers, the procedure set forth in paragraph (f)(6)(iv) of this section for requesting a determination from the IRS may be followed by the grantee organization for the protection of the grantor or contributor.

(6) *Definition of support; meaning of general public*—(i) *In general.* In determining whether the 33⅓ percent support test or the 10 percent support limitation described in paragraph (f)(3)(i) of this section is met, contributions by an individual, trust, or corporation shall be taken into account as support from direct or indirect contributions from the general public only to the extent that the total amount of the contributions by any such individual, trust, or corporation during the period described in paragraph (f)(4)(i) or paragraph (f)(4)(ii) of this section does not exceed two percent of the organization's total support for such period, except as provided in paragraph (f)(6)(ii) of this section. Therefore, for example, any contribution by one individual will be included in full in the denominator of the fraction determining the 33⅓ percent support or the 10 percent support limitation, but will be includible in the numerator of such fraction only to the extent that such amount does not exceed two percent of the denominator. In applying the two percent limitation, all contributions made by a donor and by any person or persons standing in a relationship to the donor that is described in section 4946(a)(1)(C) through (a)(1)(G) and the related regulations shall be treated as made by one person. The two percent limitation shall not apply to support received from governmental units referred to in section 170(c)(1) or to contributions from organizations described in section 170(b)(1)(A)(vi), except as provided in paragraph (f)(6)(v) of this section. For purposes of paragraphs (f)(2), (f)(3)(i), and (f)(7)(iii)(A)(*2*) of this section, the

term *indirect contributions from the general public* includes contributions received by the organization from organizations (such as section 170(b)(1)(A)(vi) organizations) that normally receive a substantial part of their support from direct contributions from the general public, except as provided in paragraph (f)(6)(v) of this section. See the examples in paragraph (f)(9) of this section for the application of this paragraph (f)(6)(i). For purposes of this paragraph (f), the term *contributions* includes qualified sponsorship payments (as defined in §1.513–4) in the form of money or property (but not services).

(ii) *Exclusion of unusual grants.* (A) For purposes of applying the two percent limitation described in paragraph (f)(6)(i) of this section to determine whether the 33⅓ percent support test or the 10 percent support limitation in paragraph (f)(3)(i) of this section is satisfied, one or more contributions may be excluded from both the numerator and the denominator of the applicable support fraction if such contributions meet the requirements of paragraph (f)(6)(iii) of this section. The exclusion provided by this paragraph (f)(6)(ii) is generally intended to apply to substantial contributions or bequests from disinterested parties, which contributions or bequests—

(*1*) Are attracted by reason of the publicly supported nature of the organization;

(*2*) Are unusual or unexpected with respect to the amount thereof; and

(*3*) Would, by reason of their size, adversely affect the status of the organization as normally being publicly supported for the applicable period described in paragraph (f)(4) of this section.

(B) In the case of a grant (as defined in §1.509(a)–3(g)) that meets the requirements of this paragraph (f)(6)(ii), if the terms of the granting instrument require that the funds be paid to the recipient organization over a period of years, the grant amounts received by the organization may be excluded for such year or years in which they would otherwise be includible in computing support under the method of accounting on the basis of which the organization regularly computes its income in keeping its books under section 446. However, no item of gross investment income may be excluded under this paragraph (f)(6). The provisions of this paragraph (f)(6) shall apply to exclude unusual grants made during any of the applicable periods described in paragraph (f)(4) or paragraph (f)(6) of this section. See paragraph (f)(6)(iv) of this section as to reliance by a grantee organization upon an unusual grant ruling under this paragraph (f)(6).

(iii) *Determining factors.* In determining whether a particular contribution may be excluded under paragraph (f)(6)(ii) of this section, all pertinent facts and circumstances will be taken into consideration. No single factor will necessarily be determinative. For some of the factors similar to the factors to be considered, see §1.509(a)–3(c)(4).

(iv) *Grantors and contributors.* Prior to the making of any grant or contribution that will allegedly meet the requirements for exclusion under paragraph (f)(6)(ii) of this section, a potential grantee organization may request a determination whether such grant or contribution may be so excluded. Requests for such determination may be filed by the grantee organization in the time and manner specified by revenue procedure or other guidance published in the Internal Revenue Bulletin. The issuance of such determination will be at the sole discretion of the Commissioner. The organization must submit all information necessary to make a determination on the factors referred to in paragraph (f)(6)(iii) of this section. If a favorable determination is issued, such determination may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 642(c), 4942, 4945, 4966, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of paragraph (f)(6)(ii) of this section.

(v) *Grants from public charities.* Pursuant to paragraph (f)(6)(i) of this section, contributions received from a governmental unit or from a section 170(b)(1)(A)(vi) organization are not subject to the two percent limitation described in paragraph (f)(6)(i) of this section unless such contributions represent amounts which have been expressly or impliedly earmarked by a donor to such governmental unit or section 170(b)(1)(A)(vi) organization as being for, or for the benefit of, the particular organization claiming section 170(b)(1)(A)(vi) status. See §1.509(a)–3(j)(3) for examples illustrating the rules of this paragraph (f)(6)(v).

(7) *Definition of support; special rules and meaning of terms*—(i) *Definition of support.* For purposes of this paragraph (f), the term ''support'' shall be as defined in section 509(d) (without regard to section 509(d)(2)). The term ''support'' does not include—

(A) Any amounts received from the exercise or performance by an organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a). In general, such amounts include amounts received from any activity the conduct of which is substantially related to the furtherance of such purpose or function (other than through the production of income); or

(B) Contributions of services for which a deduction is not allowable.

(ii) For purposes of the 33⅓ percent support test and the 10 percent support limitation in paragraph (f)(3)(i) of this section, all amounts received that are described in paragraph (f)(7)(i)(A) or paragraph (f)(7)(i)(B) of this section are to be excluded from both the numerator and the denominator of the fractions determining compliance with such tests, except as provided in paragraph (f)(7)(iii) of this section.

(iii) *Organizations dependent primarily on gross receipts from related activities.* (A) Notwithstanding the provisions of paragraph (f)(7)(i) of this section, an organization will not be treated as satisfying the 33⅓ percent support test or the 10 percent support limitation in paragraph (f)(3)(i) of this section if it receives—

(*1*) Almost all of its support (as defined in section 509(d)) from gross receipts from related activities; and

(*2*) An insignificant amount of its support from governmental units (without regard to amounts referred to in paragraph (f)(7)(i)(A) of this section) and contributions made directly or indirectly by the general public.

(B) *Example.* The application of this paragraph (f)(7)(iii) may be illustrated by the following example:

Example. Z, an organization described in section 501(c)(3), is controlled by A, its president. Z received $500,000 during the period consisting of the current taxable year and the four immediately preceding taxable years under a contract with the Department of Transportation, pursuant to which Z has engaged in research to improve a particular vehicle used primarily by the Federal government. During this same period, the only other support received by Z consisted of $5,000 in small contributions primarily from Z's employees and business associates. The $500,000 amount constitutes support under sections 509(d)(2) and 509(a)(2)(A). Under these circumstances, Z meets the conditions of paragraphs (f)(7)(iii)(A)(*1*) and (f)(7)(iii)(A)(*2*) of this section and will not be treated as meeting the requirements of either the 33⅓ percent support test or the facts and circumstances test. As to the rules applicable to organizations that fail to qualify under section 170(b)(1)(A)(vi) because of the provisions of this paragraph (f)(7)(iii), see section 509(a)(2) and the related regulations. For the distinction between gross receipts (as referred to in section 509(d)(2)) and gross investment income (as referred to in section 509(d)(4)), see §1.509(a)–3(m).

(iv) *Membership fees.* For purposes of this paragraph (f)(7), the term *support* shall include ''membership fees'' within the meaning of §1.509(a)–3(h) (that is, if the basic purpose for making a payment is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities).

(v) *Unrelated business activities.* The term *net income from unrelated business activities* in section 509(d)(3) includes (but is not limited to) an organization's unrelated business taxable income (UBTI) within the meaning of section 512. However, when calculating UBTI for purposes of determining support (within the meaning of this paragraph (f)(7)), section 512(a)(6) does not apply. Accordingly, in the case of an organization that derives gross income from the regular conduct of two or more unrelated business activities, support includes the aggregate of gross income from all such unrelated business activities less the aggregate of the deductions allowed with respect to all such unrelated business activities. Nonetheless, when determining support, such organization can use either its UBTI calculated under section 512(a)(6) or its UBTI calculated in the aggregate.

(8) *Support from a governmental unit.* (i) For purposes of the 33⅓ percent support test and the 10 percent support limitation described in paragraph (f)(3)(i) of this section, the term *support from a governmental unit* includes any amounts received from a governmental unit, including donations or contributions and amounts received in connection with a contract entered into with a governmental unit for the performance of services or in connection with a government research grant. However, such amounts will not constitute support from a governmental unit for such purposes if they constitute amounts received from the exercise or performance of the organization's exempt functions as provided in paragraph (f)(7)(i)(A) of this section.

(ii) For purposes of paragraph (f)(8)(i) of this section, any amount paid by a governmental unit to an organization is not to be treated as received from the exercise or performance of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a) (within the meaning of paragraph (f)(7)(i)(A) of this section) if the purpose of the payment is primarily to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public (regardless of whether part of the expense of providing such service or facility is paid for by the public), rather than to serve the direct and immediate needs of the payor. For example—

(A) Amounts paid for the maintenance of library facilities which are open to the public;

(B) Amounts paid under government programs to nursing homes or homes for the aged in order to provide health care or domiciliary services to residents of such facilities; and

(C) Amounts paid to child placement or child guidance organizations under government programs for services rendered to children in the community, are considered payments the purpose of which is primarily to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public, rather than to serve the direct and immediate needs of the payor. Furthermore, any amount received from a governmental unit under circumstances such that the amount would be treated as a ''grant'' within the meaning of §1.509(a)–3(g) will generally constitute ''support from a governmental unit'' described in this paragraph (f)(8), rather than an amount described in paragraph (f)(7)(i)(A) of this section.

(9) *Examples.* The application of paragraphs (f)(1) through (f)(8) of this section may be illustrated by the following examples:

Example 1. (i) M is recognized as an organization described in section 501(c)(3). For the years 2008 through 2012 (the applicable period with respect to the taxable year 2012 under paragraph (f)(4) of this section), M received support (as defined in paragraphs (f)(6) through (8) of this section) of $600,000 from the following sources:

Investment income	$300,000
City R (a governmental unit described in section 170(c)(1))	40,000
United Fund (an organization described in section 170(b)(1)(A)(vi))	40,000
Contributions (including six contributions in excess of the two-percent limit, totaling $170,000)	220,000
Total support	600,000

(ii) With respect to the taxable year 2012, M's public support is computed as follows:

Support from a governmental unit described in section 170(c)(1)	$40,000
Indirect contributions from the general public (United Fund)	40,000
Contributions by various donors that were not in excess of $12,000, or two percent of total support	50,000

Six contributions that were each in excess of $12,000, or two percent of total support, up to the two-percent limitation, 6 × $12,000	72,000
Total support	202,000

(iii) M's support from governmental units referred to in section 170(c)(1) and from direct and indirect contributions from the general public (as defined in paragraph (f)(6) of this section) with respect to the taxable year 2012 normally exceeds 33⅓ percent of M's total support ($202,000/$600,000 = 33.67 percent) for the applicable period (2008 through 2012). M meets the 33⅓ percent support test with respect to 2012 and is therefore publicly supported for the taxable years 2012 and 2013.

Example 2. (i) N is recognized as an organization described in section 501(c)(3). It was created to maintain public gardens containing botanical specimens and displaying statuary and other art objects. The facilities, works of art, and a large endowment were all contributed by a single contributor. The members of the governing body of the organization are unrelated to its creator. The gardens are open to the public without charge and attract a substantial number of visitors each year. For the current taxable year and the four taxable years immediately preceding the current taxable year, 95 percent of the organization's total support was received from investment income from its original endowment. N also maintains a membership society that is supported by members of the general public who wish to contribute to the upkeep of the gardens by paying a small annual membership fee. Over the five-year period in question, these fees from the general public constituted the remaining five percent of the organization's total support for such period.

(ii) Under these circumstances, N does not meet the 33⅓ percent support test for its current taxable year. Furthermore, because only five percent of its total support is, with respect to the current taxable year, normally received from the general public, N does not satisfy the 10 percent support limitation described in paragraph (f)(3)(i) of this section and therefore does not qualify as publicly supported under the facts and circumstances test. Because N has failed to satisfy the 10 percent support limitation under paragraph (f)(3)(i) of this section, none of the other requirements or factors set forth in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(E) of this section can be considered in determining whether N qualifies as a publicly supported organization. For its current taxable year, therefore, N is not an organization described in section 170(b)(1)(A)(vi).

Example 3. (i) O, an art museum, is recognized as an organization described in section 501(c)(3). In 1930, O was founded in S City by the members of a single family to collect, preserve, interpret, and display to the public important works of art. O is governed by a Board of Trustees that originally consisted almost entirely of members of the founding family. However, since 1945, members of the founding family or persons standing in a relationship to the members of such family described in section 4946(a)(1)(C) through (G) have annually constituted less than one-fifth of the Board of Trustees. The remaining board members are citizens of S City from a variety of professions and occupations who represent the interests and views of the people of S City in the activities carried on by the organization rather than the personal or private interests of the founding family. O solicits contributions from the general public and, for the current taxable year and each of the four taxable years immediately preceding the current taxable year, O has received total contributions (in small sums of less than $100, none of which exceeds two percent of O's total support for such period) in excess of $10,000. These contributions from the general public (as defined in paragraph (f)(6) of this section) represent 25 percent of the organization's total support for such five-year period. For this same period, investment income from several large endowment funds has constituted 75 percent of O's total support. O expends substantially all of its annual income for its exempt purposes and thus depends upon the funds it annually solicits from the public as well as its investment income in order to carry out its activities on a normal and continuing basis and to acquire new works of art. O has, for the entire period of its existence, been open to the public and more than 300,000 people (from S City and elsewhere) have visited the museum in each of the current taxable year and the four immediately preceding taxable years.

(ii) Under these circumstances, O does not meet the 33⅓ percent support test for its current year because it has received only 25 percent of its total support for the applicable five-year period from the general public. However, under the facts set forth above, O meets the 10 percent support limitation under paragraph (f)(3)(i) of this section, as well as the requirements of paragraph (f)(3)(ii) of this section. Under all of the facts set forth in this example, O is considered as meeting the requirements of the facts and circumstances test on the basis of satisfying paragraphs (f)(3)(i) and (f)(3)(ii) of this section and the factors set forth in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(D) of this section. O is therefore publicly supported for its current taxable year and the immediately succeeding taxable year.

Example 4. (i) In 1960, the P Philharmonic Orchestra was organized in T City through the combined efforts of a local music society and a local women's club to present to the public a wide variety of musical programs intended to foster music appreciation in the community. P is recognized as an organization described in section 501(c)(3). The orchestra is composed of professional musicians who are paid by the association. Twelve performances open to the public are scheduled each year. A small admission fee is charged for each of these performances. In addition, several performances are staged annually without charge. During the current taxable year and the four taxable years immediately preceding the current taxable year, P has received separate contributions of $200,000 each from A and B (not members of a single family) and support of $120,000 from the T Community Chest, a public federated fundraising organization operating in T City. P depends on these funds in order to carry out its activities and will continue to depend on contributions of this type to be made in the future. P has also begun a fundraising campaign in an attempt to expand its activities for the coming years. P is governed by a Board of Directors comprised of five individuals. A faculty member of a local college, the president of a local music society, the head of a local banking institution, a prominent doctor, and a member of the governing body of the local chamber of commerce currently serve on P's Board and represent the interests and views of the community in the activities carried on by P.

(ii) With respect to P's current taxable year, P's sources of support are computed on the basis of the current taxable year and the four taxable years immediately preceding the current taxable year, as follows:

Contributions	$520,000
Receipts from performances	100,000
Total support	620,000
Less:	
Receipts from performances (excluded under paragraph (f)(7)(i)(A) of this section)	100,000
Total support for purposes of paragraphs (f)(2) and (f)(3)(i) of this section	520,000

(iii) For purposes of paragraphs (f)(2) and (f)(3)(i) of this section, P's public support is computed as follows:

T Community Chest (indirect support from the general public)	120,000
Two contributions from A & B (each in excess of $10,400 − 2 percent of total support) 2 × $10,400	20,800
Total	140,800

(iv) Under these circumstances, P does not meet the 33⅓ percent support test for its current year because it has received only 27 percent of its total support ($140,800/$520,000) for the applicable five-year period from the general public. However, under the facts set forth above, P meets the 10 percent support limitation under paragraph (f)(3)(i) of this section, as well as the requirements of paragraph (f)(3)(ii) of this section. Under all of the facts set forth in this example, P is considered as meeting the requirements of the facts and circumstances test on the basis of satisfying paragraphs (f)(3)(i) and (f)(3)(ii) of this section and the factors set forth in paragraphs (f)(3)(iii)(A) through (f)(3)(iii)(D) of this section. P is therefore publicly supported for its current taxable year and the immediately succeeding taxable year.

Example 5. (i) Q is recognized as an organization described in section 501(c)(3). It is a philanthropic organization founded in 1965 by C for the purpose of making annual contributions to worthy charities. C created Q as a charitable trust by the transfer of appreciated securities worth $500,000 to Q. Pursuant to the trust agreement, C and two other members of his family are the sole trustees of Q and are vested with the right to appoint successor trustees. In each of the current taxable year and the four taxable years immediately preceding the current taxable year, Q received $12,000 in investment income from its original endowment. Each year Q makes a solicitation for funds by operating a charity ball at C's residence. Guests are invited and requested to make contributions of $100 per couple. During the five-year period at issue, $15,000 was received from the proceeds of these events. C and his family have also made contributions to Q of $25,000 over the five-year period at issue. Q makes disbursements each year of substantially all of its net income to the public charities chosen by the trustees.

(ii) Q's sources of support for the current taxable year and the four taxable years immediately preceding the current taxable year as follows:

Investment income	$60,000
Contributions	40,000
Total support	100,000

(iii) For purposes of paragraphs (f)(2) and (f)(3)(i) of this section, Q's public support is computed as follows:

Contributions from the general public	$ 15,000
C's contribution (in excess of $ 2,000 − 2 percent of total support) 1 × $2,000	2,000
Total	17,000

(iv) Under these circumstances, Q does not meet the 33⅓ percent support test for its current year because it has received only 17 percent of its total support ($17,000/$100,000) for the applicable five-year period from the general public. Thus, Q's classification as a ''publicly supported'' organization depends on whether it meets the requirements of the facts and circumstances test. Even though it satisfies the 10 percent support limitation under paragraph (f)(3)(i) of this section, its method of solicitation makes it questionable whether Q satisfies the requirements of paragraph (f)(3)(ii) of this section. Because of its method of operating, Q also has a greater burden of establishing its publicly supported nature under paragraph (f)(3)(iii)(A) of this section. Based upon the foregoing facts and circumstances, including Q's failure to receive favorable consideration under the factors set forth in paragraphs (f)(3)(iii)(B), (f)(3)(iii)(C), and (f)(3)(iii)(D) of this section, Q does not satisfy the facts and circumstances test.

(10) *Community trust; introduction.* Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body. To qualify as a ''publicly supported'' organization, a community trust must meet the 33⅓ percent support test, or, if it cannot meet that test, be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the facts and circumstances test. Such facts and circumstances test includes a requirement of attraction of public support in paragraph (f)(3)(ii) of this section which, as applied to community trusts, generally will be satisfied if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways that call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community or area served. A community trust is not required to engage in periodic, community-wide, fundraising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a

community chest or united fund. Paragraph (f)(11) of this section provides rules for determining the extent to which separate trusts or funds may be treated as component parts of a community trust, fund, or foundation (herein collectively referred to as a ''community trust,'' and sometimes referred to as an ''organization'') for purposes of meeting the requirements of this paragraph for classification as a publicly supported organization. Paragraph (f)(12) of this section contains rules for trusts or funds that are prevented from qualifying as component parts of a community trust by paragraph (f)(11) of this section.

(11) *Community trusts; requirements for treatment as a single entity*—(i) *General rule.* For purposes of sections 170, 501, 507, 508, 509, and Chapter 42, any organization that meets the requirements contained in paragraphs (f)(11)(iii) through (f)(11)(vi) of this section will be treated as a single entity, rather than as an aggregation of separate funds, and except as otherwise provided, all funds associated with such organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) which meet the requirements of paragraph (f)(11)(ii) of this section will be treated as component parts of such organization.

(ii) *Component part of a community trust.* In order to be treated as a component part of a community trust referred to in this paragraph (f)(11) (rather than as a separate trust or not-for-profit corporation or association), a trust or fund:

(A) Must be created by a gift, bequest, legacy, devise, or other transfer to a community trust which is treated as a single entity under this paragraph (f)(11); and

(B) May not be directly or indirectly subjected by the transferor to any material restriction or condition (within the meaning of §1.507–2(a)(7)) with respect to the transferred assets. For purposes of this paragraph (f)(11)(ii)(B), if the transferor is not a private foundation, the provisions of §1.507–2(a)(7) shall be applied to the trust or fund as if the transferor were a private foundation established and funded by the person establishing the trust or fund and such foundation transferred all its assets to the trust or fund. Any transfer made to a fund or trust which is treated as a component part of a community trust under this paragraph (f)(11)(ii) will be treated as a transfer made ''to'' a ''publicly supported'' community trust for purposes of sections 170(b)(1)(A) and 507(b)(1)(A) if such community trust meets the requirements of section 170(b)(1)(A)(vi) as a ''publicly supported'' organization at the time of the transfer, except as provided in paragraph (f)(5)(ii) of this section or §§1.508–1(b)(4) and 1.508–1(b)(6) (relating, generally, to reliance by grantors and contributors). See also paragraphs (f)(12)(ii) and (f)(12)(iii) of this section for special provisions relating to split-interest trusts and certain private foundations described in section 170(b)(1)(F)(iii).

(iii) *Name.* The organization must be commonly known as a community trust, fund, foundation, or other similar name conveying the concept of a capital or endowment fund to support charitable activities (within the meaning of section 170(c)(1) or section 170(c)(2)(B)) in the community or area it serves.

(iv) *Common instrument.* All funds of the organization must be subject to a common governing instrument or a master trust or agency agreement (herein referred to as the ''governing instrument''), which may be embodied in a single document or several documents containing common language. Language in an instrument of transfer to the community trust making a fund subject to the community trust's governing instrument or master trust or agency agreement will satisfy the requirements of this paragraph (f)(11)(iv). In addition, if a community trust adopts a new governing instrument (or creates a corporation) to put into effect new provisions (applying to future transfers to the community trust), the adoption of such new governing instrument (or creation of a corporation with a governing instrument) which contains common language with the existing governing instrument shall not preclude the community trust from meeting the requirements of this paragraph (f)(11)(iv).

(v) *Common governing body.* (A) The organization must have a common governing body or distribution committee (herein referred to as the "governing body") which either directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all of the funds exclusively for charitable purposes (within the meaning of section 170(c)(1) or section 170(c)(2)(B)). For purposes of this paragraph (f)(11)(v), a fund is designated for specified beneficiaries only if no person is left with the discretion to direct the distribution of the fund.

(B) *Powers of modification and removal.* The fact that the exercise of any power described in this paragraph (f)(11)(v)(B) is reviewable by an appropriate State authority will not preclude the community trust from meeting the requirements of this paragraph (f)(11)(v)(B). Except as provided in paragraph (f)(11)(v)(C) of this section, the governing body must have the power in the governing instrument, the instrument of transfer, the resolutions or bylaws of the governing body, a written agreement, or otherwise—

(*1*) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if in the sole judgment of the governing body (without the necessity of the approval of any participating trustee, custodian, or agent), such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served;

(*2*) To replace any participating trustee, custodian, or agent for breach of fiduciary duty under State law; and

(*3*) To replace any participating trustee, custodian, or agent for failure to produce a reasonable (as determined by the governing body) return of net income (within the meaning of paragraph (f)(11)(v)(F) of this section) over a reasonable period of time (as determined by the governing body).

(C) *Transitional rule*—(*1*) Notwithstanding paragraph (f)(11)(v)(B) of this section, if a community trust meets the requirements of paragraph (f)(11)(v)(C)(*3*) of this section, then in the case of any instrument of transfer which is executed before July 19, 1977, and is not revoked or amended thereafter (with respect to any dispositive provision affecting the transfer to the community trust), and in the case of any instrument of transfer which is irrevocable on January 19, 1982, the governing body must have the power to cause proceedings to be instituted (by request to the appropriate State authority)—

(*i*) To modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if in the judgment of the governing body such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served; and

(*ii*) To remove any participating trustee, custodian, or agent for breach of fiduciary duty under State law.

(*2*) The necessity for the governing body to obtain the approval of a participating trustee to exercise the powers described in paragraph (f)(11)(v)(C)(*1*) of this section shall be treated as not preventing the governing body from having such power, unless (and until) such approval has been (or is) requested by the governing body and has been (or is) denied.

(*3*) Paragraph (f)(11)(v)(C)(*1*) of this section shall not apply unless the community trust meets the requirements of paragraph (f)(11)(v)(B) of this section, with respect to funds other than those under instruments of transfer described in the first sentence of such paragraph (f)(11)(v)(C)(*1*) of this section, by January 19, 1978, or such later date as the Commissioner may provide for such community trust, and unless the community trust does not, once it so complies, thereafter solicit for funds that will not qualify under the requirements of paragraph (f)(11)(v)(B) of this section.

(D) *Inconsistent State law*—(*1*) For purposes of paragraphs (f)(11)(v)(B)(*1*), (f)(11)(v)(B)(*2*), (f)(11)(v)(B)(*3*), (f)(11)(v)(C)(*1*)(i), (f)(11)(v)(C)(*1*)(ii), and (f)(11)(v)(E) of this section, if a power described in such a provision is inconsistent with State law even if such power were expressly granted to the governing body by the governing instrument and were accepted without limitation under an instrument of transfer, then the community trust will be treated as meeting the requirements of such a provision if it meets such requirements to the fullest extent possible consistent with State law (if such power is or had been so expressly granted).

(*2*) For example, if, under the conditions of paragraph (f)(11)(v)(D)(*1*) of this section, the power to modify is inconsistent with State law, but the power to institute proceedings to modify, if so expressly granted, would be consistent with State law, the community trust will be treated as meeting such requirements to the fullest extent possible if the governing body has the power (in the governing instrument or otherwise) to institute proceedings to modify a condition or restriction. On the other hand, if in such a case the community trust has only the power to cause proceedings to be instituted to modify a condition or restriction, it will not be treated as meeting such requirements to the fullest extent possible.

(*3*) In addition, if, for example, under the conditions of paragraph (f)(11)(v)(D)(*1*) of this section, the power to modify and the power to institute proceedings to modify a condition or restriction is inconsistent with State law, but the power to cause such proceedings to be instituted would be consistent with State law, if it were expressly granted in the governing instrument and if the approval of the State Attorney General were obtained, then the community trust will be treated as meeting such requirements to the fullest extent possible if it has the power (in the governing instrument or otherwise) to cause such proceedings to be instituted, even if such proceedings can be instituted only with the approval of the State Attorney General.

(E) *Exercise of powers.* The governing body shall (by resolution or otherwise) commit itself to exercise the powers described in paragraphs (f)(11)(v)(B), (f)(11)(v)(C), and (f)(11)(v)(D) of this section in the best interests of the community trust. The governing body will be considered not to be so committed where it has grounds to exercise such a power and fails to exercise it by taking appropriate action. Such appropriate action may include, for example, consulting with the appropriate State authority prior to taking action to replace a participating trustee.

(F) *Reasonable return.* In addition to the requirements of paragraphs (f)(11)(v)(B), (f)(11)(v)(C), (f)(11)(v)(D), or (f)(11)(v)(E) of this section, the governing body shall (by resolution or otherwise) commit itself to obtain information and take other appropriate steps with the view to seeing that each participating trustee, custodian, or agent, with respect to each restricted trust or fund that is, and with respect to the aggregate of the unrestricted trusts or funds that are, a component part of the community trust, administers such trust or fund in accordance with the terms of its governing instrument and accepted standards of fiduciary conduct to produce a reasonable return of net income (or appreciation where not inconsistent with the community trust's need for current income), with due regard to safety of principal, in furtherance of the exempt purposes of the community trust (except for assets held for the active conduct of the community trust's exempt activities). In the case of a low return of net income (and, where appropriate, appreciation), the IRS will examine carefully whether the governing body has, in fact, committed itself to take the appropriate steps. For purposes of this paragraph (f)(11)(v)(F), any income that has been designated by the donor of the gift or bequest to which such income is attributable as being available only for the use or benefit of a broad charitable purpose, such as the encouragement of higher education or the promotion of better health care in the community, will be treated as unrestricted. However, any income that has been designated for the use or benefit of a named charitable organization or agency or for the use or benefit of a particular class of charitable organizations or agencies, the members of which are readily ascertainable and are less than five in number, will be treated as restricted.

(vi) *Common reports.* The organization must prepare periodic financial reports treating all of the funds which are held by the community trust, either directly or in component parts, as funds of the organization.

(12) *Community trusts; treatment of trusts and not-for-profit corporations and associations not included as components.* (i) For purposes of sections 170, 501, 507, 508, 509, and Chapter 42, any trust or not-for-profit corporation or association that is alleged to be a component part of a community trust, but that fails to meet the requirements of paragraph (f)(11)(ii) of this section, shall not be treated as a component part of a community trust and, if a trust, shall be treated as a separate trust and be subject to the provisions of section 501, section 4947(a)(1), or section 4947(a)(2), as the case may be. If such organization is a not-for-profit corporation or association, it will be treated as a separate entity, and, if it is described in section 501(c)(3), it will be treated as a private foundation unless it is described in section 509(a)(1), section 509(a)(2), section 509(a)(3), or section 509(a)(4). In the case of a fund that is ultimately treated as not being a component part of a community trust pursuant to this paragraph (f)(12), if the Forms 990 filed annually by the community trust included financial information with respect to such fund and treated such fund in the same manner as other component parts thereof, such returns filed by the community trust prior to the taxable year in which the Commissioner notifies such fund that it will not be treated as a component part will be treated as its separate return for purpose of Subchapter A of Chapter 61 of Subtitle F, and the first such return filed by the community trust will be treated as the notification required of the separate entity for purposes of section 508(a).

(ii) If a transfer is made in trust to a community trust to make income or other payments for a period of a life or lives in being or a term of years to any individual or for any noncharitable purpose, followed by payments to or for the use of the community trust (such as in the case of a charitable remainder annuity trust or a charitable remainder unitrust described in section 664 or a pooled income fund described in section 642(c)(5)), such trust will be treated as a component part of the community trust upon the termination of all intervening noncharitable interests and rights to the actual possession or enjoyment of the property if such trust satisfies the requirements of paragraph (f)(11) of this section at such time. Until such time, the trust will be treated as a separate trust. If a transfer is made in trust to a community trust to make income or other payments to or for the use of the community trust, followed by payments to any individual or for any noncharitable purpose, such trust will be treated as a separate trust rather than as a component part of the community trust. See section 4947(a)(2) and the related regulations for the treatment of such split-interest trusts. The provisions of this paragraph (f)(12)(ii) provide rules only for determining when a charitable remainder trust or pooled income fund may be treated as a component part of a community trust and are not intended to preclude a community trust from maintaining a charitable remainder trust or pooled income fund. For purposes of grantors and contributors, a pooled income fund of a publicly supported community trust shall be treated no differently than a pooled income fund of any other publicly supported organization.

(iii) An organization described in section 170(b)(1)(F)(iii) will not ordinarily satisfy the requirements of paragraph (f)(11)(ii) of this section because of the unqualified right of the donor to designate the recipients of the income and principal of the trust. Such organization will therefore ordinarily be treated as other than a component part of a community trust under paragraph (f)(12)(i) of this section. However, see section 170(b)(1)(F)(iii) and the related regulations with respect to the treatment of contributions to such organizations.

(13) *Method of accounting.* For purposes of section 170(b)(1)(A)(vi), an organization's support will be determined under the method of accounting on the basis of which the organization regularly computes its income in keeping its books under section 446. For example, if a grantor makes a grant to an organization payable over a term of years, such grant will be includible in

the support fraction of the grantee organization under the method of accounting on the basis of which the grantee organization regularly computes its income in keeping its books under section 446.

(14) *Transition rules.* (i) An organization that received an advance ruling, that expires on or after June 9, 2008, that it will be treated as an organization described in sections 170(b)(1)(A)(vi) and 509(a)(1) will be treated as meeting the requirements of paragraph (f)(2) or paragraph (f)(3) of this section for the first five taxable years of its existence as a section 501(c)(3) organization unless the IRS issued to the organization a proposed determination prior to September 9, 2008, that the organization is not described in sections 170(b)(1)(A)(vi) and 509(a)(1) or in section 509(a)(2).

(ii) Paragraph (f)(4)(v) of this section shall not apply with respect to an organization that received an advance ruling that expired prior to June 9, 2008, and that did not timely file with the Internal Revenue Service the required information to establish that it is an organization described in sections 170(b)(1)(A)(vi) and 509(a)(1) or in section 509(a)(2).

(iii) An organization that fails to meet a public support test for its first taxable year beginning on or after January 1, 2008, under the regulations in this section may use the prior tests set forth in §1.170A–9(e)(2) or §1.170A–9(e)(3), or in §§1.509(a)–3(a)(2) and 1.509(a)–3(a)(3), as in effect before September 9, 2008 (as contained in 26 CFR part 1 revised April 1, 2008), to determine whether the organization was publicly supported for its 2008 taxable year based on its satisfaction of a public support test for taxable year 2007, computed over the period 2003 through 2006.

(iv) *Examples.* The application of this paragraph (f)(14) may be illustrated by the following examples:

Example 1. (i) Organization X was formed in January 2004 and uses a taxable year ending June 30. Organization X received an advance ruling letter that it is recognized as an organization described in section 501(c)(3) effective as of the date of its formation and that it is treated as a publicly supported organization under sections 170(b)(1)(A)(vi) and 509(a)(1) during the five-year advance ruling period that will end on June 30, 2008. This date is on or after June 9, 2008.

(ii) Under the transition rule, Organization X is a publicly supported organization described in sections 170(b)(1)(A)(vi) and 509(a)(1) for the taxable years ending June 30, 2004, through June 30, 2008. Organization X does not need to establish within 90 days after June 30, 2008, that it met a public support test under §1.170A–9(e) or §1.509(a)–3, as in effect prior to September 9, 2008, (as contained in 26 CFR part 1 revised April 1, 2008), for its advance ruling period.

(iii) Organization X can qualify as a publicly supported organization for the taxable year ending June 30, 2009, if Organization X can meet the requirements of paragraph (f)(2) or (f)(3) of this section or §§1.509(a)–3(a)(2) and 1.509(a)–3(a)(3) for the taxable years ending June 30, 2005, through June 30, 2009, or for the taxable years ending June 30, 2004, through June 30, 2008. In addition, for its taxable year ending June 30, 2009, Organization X may qualify as a publicly supported organization by availing itself of the transition rule contained in paragraph (f)(14)(iii) of this section, which looks to support received by X in the taxable years ending June 30, 2004, through June 30, 2007.

Example 2. (i) Organization Y was formed in January 2000, and uses a taxable year ending December 31. Organization Y received a final determination that it was recognized as tax-exempt under section 501(c)(3) and as a publicly supported organization prior to September 9, 2008.

(ii) For taxable year 2008, Organization Y will qualify as publicly supported if it meets the requirements under either paragraph (f)(2) or (f)(3) of this section or §§1.509(a)–3(a)(2) or 1.509(a)–3(a)(3) for the five-year period January 1, 2004, through December 31, 2008. Organization Y will also qualify as publicly supported for taxable year 2008 if it meets the requirements under §1.170A–9(e)(2) or §1.170A–9(e)(3), or under §§1.509(a)–3(a)(2) and 1.509(a)–3(a)(3), as in effect prior to September 9, 2008, (as contained in 26 CFR part 1 revised April 1, 2008) for taxable year 2007, using the four-year period from January 1, 2003, through December 31, 2006.

(g) *Private operating foundation.* An organization is described in section 170(b)(1) (A)(vii) and (E)(i) if it is a private ''operating foundation'' as defined in section 4942(j)(3) and the regulations thereunder.

(h) *Private nonoperating foundation distributing amount equal to all contributions received*—(1) *In general.* (i) An organization is described in section 170(b)(1) (A)(vii) and (E)(ii) if it is a private foundation which, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distributes an amount equal in value to 100 percent of all contributions received in such year. Such distributions must be qualifying distributions (as defined in section 4942(g) without regard to paragraph (3) thereof) which are treated, after the application of section 4942(g)(3), as distributions out of corpus in accordance with section 4942(h). Qualifying distributions, as defined in section 4942(g) without regard to paragraph (3) thereof, cannot be made to (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons (as defined in section 4946) with respect to the foundation or (ii) a private foundation which is not an operating foundation (as defined in section 4942(j)(3)). The phrase ''after the application of section 4942(g)(3)'' means that every contribution described in section 4942(g)(3) received by a private foundation described in this subparagraph in a particular taxable year must be distributed (within the meaning of section 4942(g)(3)(A)) by such foundation not later than the 15th day of the third month after the close of such taxable year in order for any other distribution by such foundation to be counted toward the 100-percent requirement described in this subparagraph.

(ii) In order for an organization to meet the distribution requirements of subdivision (i) of this subparagraph, it must, not later than the 15th day of the third month after the close of its taxable year in which any contributions are received, distribute (within the meaning of subdivision (i) of this subparagraph) an amount equal in value to 100 percent of all contributions received in such year and have no remaining undistributed income for such year.

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

Example 1. X is a private foundation on a calendar year basis. As of January 1, 1971, X had no undistributed income for 1970. X's distributable amount for 1971 was $600,000. In July 1971, A, an individual, contributed $500,000 (fair market value determined at the time of the contribution) of appreciated property to X (which, if sold, would give rise to long-term capital gain). X did not receive any other contribution in either 1970 or 1971. During 1971, X made qualifying distributions of $700,000 which were treated as made out of the undistributed income for 1971 and $100,000 out of corpus. X will meet the requirements of section 170(b)(1)(E)(ii) for 1971 if it makes additional qualifying distributions of $400,000 out of corpus by March 15, 1972.

Example 2. Assume the facts as stated in *Example 1,* except that as of January 1, 1971, X had $100,000 of undistributed income for 1970. Under these circumstances, the $700,000 distributed by X in 1971 would be treated as made out of the undistributed income for 1970 and 1971. X would therefore have to make additional qualifying distributions of $500,000 out of corpus between January 1, 1972, and March 15, 1972, in order to meet the requirements of section 170(b)(1)(E)(ii) for 1971.

(2) *Special rules.* In applying subparagraph (1) of this paragraph:

(i) For purposes of section 170(b)(1)(A)(vii), an organization described in section 170(b)(1)(E)(ii) must distribute all contributions received in any year, whether of cash or property. However, solely for purposes of section 170(e)(1)(B)(ii), an organization described in section 170(b)(1)(E)(ii) is required to distribute all contributions of property only received in any year. Contributions for purposes of this paragraph do not include bequests, legacies, devises, or transfers within the meaning of section 2055 or 2106(a)(2) with respect to which a deduction was not allowed under section 170.

(ii) Any distributions made by a private foundation pursuant to subparagraph (1) of this paragraph with respect to a particular taxable year shall be treated as made first out of contributions of property and then out of contributions of cash received by such foundation in such year.

(iii) A private foundation is not required to trace specific contributions of property, or amounts into which such contributions are converted, to specific distributions.

(iv) For purposes of satisfying the requirements of section 170(b)(1)(D)(ii), except as provided to the contrary in this subdivision (iv), the fair market value of contributed property, determined on the date of contribution, is required to be used for purposes of determining whether an amount equal in value to 100 percent of the contribution received has been distributed. However, reasonable selling expenses, if any, incurred by the foundation in the sale of the contributed property may be deducted from the fair market value of the contributed property on the date of contribution, and distribution of the balance of the fair market value will satisfy the 100 percent distribution requirement. If a private foundation receives a contribution of property and, within 30 days thereafter, either sells the property or makes an in kind distribution of the property to a public charity, then at the choice of the private foundation the gross amount received on the sale (less reasonable selling expenses incurred) or the fair market value of the contributed property at the date of its distribution to the public charity, and not the fair market value of the contributed property on the sale of contribution (less reasonable selling expenses, if any), is considered to be the amount of the fair market value of the contributed property for purposes of the requirements of section 170(b)(1)(D)(ii).

(v) A private foundation may satisfy the requirements of subparagraph (1) of this paragraph for a particular taxable year by electing (pursuant to section 4942(h)(2) and the regulations thereunder) to treat a portion or all of one or more distributions, made not later than the 15th day of the third month after the close of such year, as made out of corpus.

(3) *Transitional rules*—(i) *Taxable years beginning before January 1, 1970, and ending after December 31, 1969*. In order for an organization to meet the distribution requirements of subparagraph (1)(i) of this paragraph for a taxable year which begins before January 1, 1970, and ends after December 31, 1969, it must, not later than the 15th day of the third month after the close of such taxable year, distribute (within the meaning of subparagraph (1)(i) of this paragraph) an amount equal in value to 100 percent of all contributions (other than contributions described in section 4942(g)(3)) which were received between January 1, 1970, and the last day of such taxable year. Because the organization is not subject to the provisions of section 4942 for such year, the organization need not satisfy subparagraph (1)(ii) of this paragraph or the phrase ''after the application of section 4942(g)(3)'' for such year.

(ii) *Extension of period*. For purposes of section 170(b)(1)(A)(vii) and 170(e)(1)(B)(ii), in the case of a taxable year ending in either 1970, 1971 or 1972, the period referred to in section 170(b)(1)(E)(ii) for making distributions shall not expire before April 2, 1973.

(4) *Adequate records required*. A taxpayer claiming a deduction under section 170 for a charitable contribution to a foundation described in subparagraph (1) of this paragraph must obtain adequate records or other sufficient evidence from such foundation showing that the foundation made the required qualifying distributions within the time prescribed. Such records or other evidence must be attached to the taxpayer's return for the taxable year for which the charitable contribution deduction is claimed. If necessary, an amended income tax return or claim for refund may be filed in accordance with §301.6402–2 and §301.6402–3 of this chapter (procedure and administration regulations).

(i) *Private foundation maintaining a common fund*—(1) *Designation by substantial contributors*. An organization is described in section 170(b)(1) (A)(vii) and (E)(iii) if it is a private foundation all of the contributions to which are pooled in a common fund and which would be described in section 509(a)(3) but for the right of any donor who is a substantial contributor or his spouse to designate annually the recipients, from among public charities, of the income attributable to the donor's contribution to the fund and to direct (by deed or by will) the payment, to public charities, of the corpus in the common fund attributable to the donor's contribution. For purposes of this paragraph, the private foundation is to be treated as meeting the requirements of section 509(a)(3) (A) and (B) even though donors to the foundation, or their spouses, retain the right to, and in fact do, designate public charities to receive income or corpus from the fund.

(2) *Distribution requirements*. To qualify under subparagraph (1) of this paragraph, the private foundation described therein must be required by its governing instrument to distribute, and it

must in fact distribute (including administrative expenses):

(i) All of the adjusted net income (as defined in section 4942(f)) of the common fund to one or more public charities not later than the 15th day of the third month after the close of the taxable year in which such income is realized by the fund, and

(ii) All the corpus attributable to any donor's contribution to the fund to one or more public charities not later than 1 year after the donor's death or after the death of the donor's surviving spouse if such surviving spouse has the right to designate the recipients of such corpus.

(3) *Failure to designate.* A private foundation will not fail to qualify under this paragraph merely because a substantial contributor or his spouse fails to exercise his right to designate the recipients of income or corpus of the fund, provided that the income and corpus attributable to his contribution are distributed as required by subparagraph (2) of this paragraph.

(4) *Definitions.* For purposes of this paragraph:

(i) The term *substantial contributor* is as defined in section 507(d)(2) and the regulations thereunder.

(ii) The term *public charity* means an organization described in section 170(b)(1)(A) (i) through (vi). If an organization is described in section 170(b)(1)(A) (i) through (vi), and is also described in section 170(b)(1)(A)(viii), it shall be treated as a public charity for purposes of this paragraph.

(iii) The term *income attributable to* means the income earned by the fund which is properly allocable to the contributed amount by any reasonable and consistently applied method. See, for example, §1.642(c)–5(c).

(iv) The term *corpus attributable to* means the portion of the corpus of the fund attributable to the contributed amount. Such portion may be determined by any reasonable and consistently applied method.

(v) The term *donor* means any individual who makes a contribution (whether of cash or property) to the private foundation, whether or not such individual is a substantial contributor.

(j) *Section 509(a) (2) or (3) organization.* An organization is described in section 170(b)(1)(A)(viii) if it is described in section 509(a) (2) or (3) and the regulations thereunder.

(k) *Effective/applicability date*—(1) *In general.* These regulations shall apply to taxable years beginning after December 31, 1969.

(2) *Applicability date.* The regulations in paragraph (f) of this section shall apply to taxable years beginning on or after January 1, 2008. For tax years beginning after December 31, 1969, and beginning before January 1, 2008, see §1.170A–9(e) (as contained in 26 CFR part 1 revised April 1, 2008).

(3) *Applicability date.* Paragraph (f)(7)(v) of this section applies to taxable years beginning on or after December 2, 2020. Taxpayers may choose to apply this section to taxable years beginning on or after January 1, 2018, and before December 2, 2020.

[T.D. 7242, 38 FR 12, Jan. 3, 1973; 38 FR 3598, Feb. 8, 1973, as amended by T.D. 7406, 41 FR 7096, Feb. 17, 1976; T.D. 7440, 41 FR 50650, Nov. 17, 1976; T.D. 7456, 42 FR 4436, Jan. 25, 1977; T.D. 7679, 45 FR 13452, Feb. 29, 1980; T.D. 8100, 51 FR 31614, Sept. 4, 1986; T.D. 8991, 67 FR 20437, Apr. 25, 2002; T.D. 9423, 73 FR 52533, Sept. 9, 2008; T.D. 9549, 76 FR 55750, Sept. 8, 2011; T.D. 9933, 85 FR 77978, Dec. 2, 2020]

§ 1.170A–10 Charitable contributions carryovers of individuals.

(a) *In general.* (1) Section 170(d)(1), relating to carryover of charitable contributions in excess of 50 percent of contribution base, and section 170(b)(1)(D)(ii), relating to carryover of charitable contributions in excess of 30 percent of contribution base, provide for excess charitable contributions carryovers by individuals of charitable contributions to section 170(b)(1)(A) organizations described in §1.170A–9. These carryovers shall be determined as provided in paragraphs (b) and (c) of this section. No excess charitable contributions carryover shall be allowed with respect to contributions ''for the use of,'' rather than ''to,'' section 170(b)(1)(A) organizations or with respect to contributions ''to'' or ''for the use of'' organizations which are not section 170(b)(1)(A) organizations. See §1.170A–8(a)(2) for definitions of ''to'' or ''for the use of'' a charitable organization.

(2) The carryover provisions apply with respect to contributions made during a taxable year in excess of the applicable percentage limitation even though the taxpayer elects under section 144 to take the standard deduction in that year instead of itemizing the deduction allowable in computing taxable income for that year.

(3) For provisions requiring a reduction of the excess charitable contribution computed under paragraph (b)(1) or (c)(1) of this section when there is a net operating loss carryover to the taxable year, see paragraph (d)(1) of this section.

(4) The provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section do not apply to contributions by an estate; nor do they apply to a trust unless the trust is a private foundation which, pursuant to §1.642(c)–4, is allowed a deduction under section 170 subject to the provisions applicable to individuals.

(b) *50-percent charitable contributions carryover of individuals*—(1) *Computation of excess of charitable contributions made in a contribution year.* Under section 170(d)(1), subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions made by an individual in a taxable year (hereinafter) in this paragraph referred to as the ''contribution year'') to section 170(b)(1)(A) organizations described in §1.170A–9, over

(ii) 50 percent of his contribution base, as defined in section 170(b)(1)(F), for such contribution year, shall be treated as a charitable contribution paid by him to a section 170(b)(1)(A) organization in each of the 5 taxable years immediately succeeding the contribution year in order of time. However, such excess to the extent it consists of contributions of 30-percent capital gain property, as defined in §1.170A–8(d)(3), shall be subject to the rules of section 170(b)(1)(D)(ii) and paragraph (c) of this section in the years to which it is carried over. A charitable contribution made in a taxable year beginning before January 1, 1970, to a section 170(b)(1)(A) organization and carried over to a taxable year beginning after December 31, 1969, under section 170(b)(5) (before its amendment by the Tax Reform Act of 1969) shall be treated in such taxable year beginning after December 31, 1969, as a charitable contribution of cash subject to the limitations of this paragraph, whether or not such carryover consists of contributions of 30-percent capital gain property or of ordinary income property described in §1.170A–4(b)(1). For purposes of applying this paragraph and paragraph (c) of this section, such a carryover from a taxable year beginning before January 1, 1970, which is so treated as paid to a section 170(b)(1)(A) organization in a taxable year beginning after December 31, 1969, shall be treated as paid to such an organization under section 170(d)(1) and this section. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have a contribution base for 1970 of $50,000 and for 1971 of $40,000 and file a joint return for each year. Assume further that in 1970 they make a charitable contribution in cash of $26,500 to a church and $1,000 to X (not a section 170(b)(1)(A) organization) and in 1971 they make a charitable contribution in cash of $19,000 to a church and $600 to X. They may claim a charitable contributions deduction of $25,000 in 1970, and the excess of $26,500 (contribution to the church) over $25,000 (50 percent of contribution base), or $1,500, constitutes a charitable contributions carryover which shall be treated as a charitable contribution paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. No carryover is allowed with respect to the $1,000 contribution made to X in 1970. Since 50 percent of their contribution base for 1971 ($20,000) exceeds the charitable contributions of $19,000 made by them in 1971 to section 170(b)(1)(A) organizations (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the portion of the 1970 carryover equal to such excess of $1,000 ($20,000 minus $19,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971; the remaining $500 constitutes an unused charitable contributions carryover. No deduction for 1971, and no carryover, are allowed with respect to the $600 contribution made to X in 1971.

Example 2. Assume the same facts as in *Example 1* except that H and W have a contribution base for 1971 of $42,000. Since 50 percent of their contribution base for 1971 ($21,000) exceeds by $2,000 the charitable contribution of $19,000 made by them in 1971 to the section 170(b)(1)(A) organization (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the full amount of the 1970 carryover of $1,500 is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971. They may also claim a charitable contribution of $500 ($21,000 − $20,500[$19,000 + $1,500]) with respect to the gift to X in 1971. No carryover is allowed with respect to the $100 ($600 − $500) of the contribution to X which is not deductible in 1971.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year*. In applying the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of such subparagraph and paragraph (d)(1) of this section which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to a section 170(b)(1)(A) organization shall not exceed the lesser of the amounts computed under subdivisions (i) to (iii), inclusive, of this subparagraph:

(i) The amount by which 50 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(*a*) The charitable contributions actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations, and

(*b*) The charitable contributions, other than contributions of 30-percent capital gain property, made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year which, pursuant to the provisions of section 170(d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contribution in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section.

(iii) In the case of the second, third, fourth, and fifth taxable years succeeding the contribution year, the portion of the excess charitable contribution in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section, which has not been treated as paid to a section 170(b)(1)(A) organization in a year intervening between the contribution year and such succeeding taxable year.

For purposes of applying subdivision (i)(*a*) of this subparagraph, the amount of charitable contributions of 30-percent capital gain property actually made in a taxable year succeeding the contribution year shall be determined by first applying the 30-percent limitation of section 170(b)(1)(D)(i) and paragraph (d) of § 1.170A–8. If a taxpayer, in any one of the 4 taxable years succeeding a contribution year, elects under section 144 to take the standard deduction instead of itemizing the deductions allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in such standard deduction year the lesser of the amounts determined under subdivisions (i) to (iii), inclusive, of this subparagraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that B has a contribution base for 1970 of $20,000 and for 1971 of $30,000. Assume further that in 1970 B contributed $12,000 in cash to a church and in 1971 he contributed $13,500 in cash to the church. B may claim a charitable contributions deduction of $10,000 in 1970, and the excess of $12,000 (contribution to the church) over $10,000 (50 percent of B's contribution base), or $2,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution paid by B to a section 170(b)(1)(A) organization in the 5 taxable years succeeding 1970 in order of time. B may claim a charitable contributions deduction of $15,000 in 1971. Such $15,000 consists of the $13,500 contribution to the church in 1971 and $1,500 carried over from 1970 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1971. The $1,500 contribution treated as paid in 1971 is computed as follows:

1970 excess contributions		$2,000
50 percent of B's contribution base for 1971		15,000
Less:		
Contributions actually made in 1971 to section 170(b)(1)(A) organizations	$13,500	
Contributions made to section 170(b)(1)(A) organizations in taxable years prior to 1970 treated as having been paid in 1971	0	13,500
Balance		1,500

Amount of 1970 excess treated as paid in 1971—the lesser of $2,000 (1970 excess contributions) or $1,500 (excess of 50 percent of contribution base for 1971 ($15,000) over the sum of the section 170(b)(1)(A) contributions actually made in 1971 ($13,500) and the section 170(b)(1)(A) contributions made in years prior to 1970 treated as having been paid in 1971 ($0))	1,500

If the excess contributions made by B in 1970 had been $1,000 instead of $2,000, then, for purposes of this example, the amount of the 1970 excess treated as paid in 1971 would be $1,000 rather than $1,500.

Example 2. Assume the same facts as in *Example 1,* and, in addition, that B has a contribution base for 1972 of $10,000 and for 1973 of $20,000. Assume further with respect to 1972 that B elects under section 144 to take the standard deduction in computing taxable income and that his actual contributions to section 170(b)(1)(A) organizations in that year are $300 in cash. Assume further with respect to 1973 that R itemizes his deductions, which include a $5,000 cash contribution to a church. B's deductions for 1972 are not increased by reason of the $500 available as a charitable contributions carryover from 1970 (excess contributions made in 1970 ($2,000) less the amount of such excess treated as paid in 1971 ($1,500)), since B elected to take the standard deduction in 1972. However, for purposes of determining the amount of the excess charitable contributions made in 1970 which is available as a carryover to 1973, B is required to treat such $500 as a charitable contribution paid in 1972—the lesser of $500 or $4,700 (50 percent of contribution base ($5,000) over contributions actually made in 1972 to section 170(b)(1)(A) organizations ($300)). Therefore, even though the $5,000 contribution made by B in 1973 to a church does not amount to 50 percent of B's contribution base for 1973 (50 percent of $20,000), B may claim a charitable contributions deduction of only the $5,000 actually paid in 1973 since the entire excess charitable contribution made in 1970 ($2,000) has been treated as paid in 1971 ($1,500) and 1972 ($500).

Example 3. Assume the following factual situation for C who itemizes his deductions in computing taxable income for each of the years set forth in the example:

	1970	1971	1972	1973	1974
Contribution base	$10,000	$7,000	$15,000	$10,000	$9,000
Contributions of cash to section 170(b)(1)(A) organizations (no other contributions)	6,000	4,400	8,000	3,000	1,500
Allowable charitable contributions deductions computed without regard to carryover of contributions	5,000	3,500	7,500	3,000	1,500
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	1,000	900	500	0	0

Since C's contributions in 1973 and 1974 to section 170(b)(1)(A) organizations are less than 50 percent of his contribution base for such years, the excess contributions for 1970, 1971, and 1972 are treated as having been paid to section 170(b)(1)(A) organizations in 1973 and 1974 as follows:

1973

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1973	Available charitable contributions carryovers
1970	$1,000	0	$1,000
1971	900	0	900
1972	500	0	500
Total			2,400
50 percent of B's contribution base for 1973			$5,000
Less: Charitable contributions made in 1973 to section 170(b)(1)(A) organizations			3,000
			2,000
Amount of excess contributions treated as paid in 1973—lesser of $2,400 (available carryovers to 1973) or $2,000 (excess of 50 percent of contribution base ($5,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($3,000))			2,000

1974

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1974	Available charitable contributions carryovers
1970	$1,000	$1,000	
1971	900	900	
1972	500	100	$40

1974

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1974	Available charitable contributions carryovers
1973	0	0	
Total			400
50 percent of B's contribution base for 1974			$4,500
Less: Charitable contributions made in 1974 to section 170(b)(1)(A) organizations			1,500
			3,000
Amount of excess contributions treated as paid in 1974—the lesser of $400 (available carryovers to 1974) or $3,000 (excess of 50 percent of contribution base ($4,500) over contributions actually made in 1974 to section 170(b)(1)(A) organizations ($1,500))			400

(c) *30-percent charitable contributions carryover of individuals*—(1) *Computation of excess of charitable contributions made in a contribution year.* Under section 170(b)(1)(D)(ii), subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions of 30-percent capital gain property, as defined in §1.170A–8(d)(3), made by an individual in a taxable year (hereinafter in this paragraph referred to as the ''contribution year'') to section 170(b)(1)(A) organizations described in §1.170A–9, over

(ii) 30 percent of his contribution base for such contribution year, shall, subject to section 170(b)(1)(A) and paragraph (b) of §1.170A–8, be treated as a charitable contribution of 30-percent capital gain property paid by him to a section 170(b)(1)(A) organization in each of the 5 taxable years immediately succeeding the contribution year in order of time. In addition, any charitable contribution of 30-percent capital gain property which is carried over to such years under section 170(d)(1) and paragraph (b) of this section shall also be treated as though it were a carryover of 30-percent capital gain property under section 170(b)(1)(D)(ii) and this paragraph. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have a contribution base for 1970 of $50,000 and for 1971 of $40,000 and file a joint return for each year. Assume further that in 1970 they contribute $20,000 cash and $13,000 of 30-percent capital gain property to a church, and that in 1971 they contribute $5,000 cash and $10,000 of 30-percent capital gain property to a church. They may claim a charitable contributions deduction of $25,000 in 1970 and the excess of $33,000 (contributed to the church) over $25,000 (50 percent of contribution base), or $8,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution of 30-percent capital gain property paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. Since 30 percent of their contribution base for 1971 ($12,000) exceeds the charitable contributions of 30-percent capital gain property ($10,000) made by them in 1971 to section 170(b)(1)(A) organizations (computed without regard to section 170 (b)(1)(D)(ii) and (d)(1) and this section), the portion of the 1970 carryover equal to such excess of $2,000 ($12,000—$10,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1971; the remaining $6,000 constitutes an unused charitable contributions carryover in respect of 30-percent capital gain property from 1970.

Example 2. Assume the same facts as in *Example 1* except the $33,000 of charitable contributions in 1970 are all 30-percent capital gain property. Since their charitable contributions in 1970 exceed 30 percent of their contribution base ($15,000) by $18,000 ($33,000—$15,000), they may claim a charitable contributions deduction of $15,000 in 1970, and the excess of $33,000 over $15,000, or $18,000, constitutes a charitable contributions carryover which shall be treated as a charitable contribution of 30-percent capital gain property paid by them to a section 170(b)(1)(A) organization in each of the 5 succeeding taxable years in order of time. Since they are allowed to treat only $2,000 of their 1970 contribution as paid in 1971, they have a remaining unused charitable contributions carryover of $16,000 in respect of 30-percent capital gain property from 1970.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year.* In applying the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of such subparagraph and paragraph (d)(1) of this section which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to a section 170(b)(1)(A) organization shall not exceed the least of the amounts computed under subdivisions (i) to (iv), inclusive, of this subparagraph:

(i) The amount by which 30 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(*a*) The charitable contributions of 30-percent capital gain property actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations, and

(*b*) The charitable contributions of 30-percent capital gain property made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year, which, pursuant to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(ii) The amount by which 50 percent of the taxpayer's contribution base for such succeeding taxable year exceeds the sum of:

(*a*) The charitable contributions actually made (computed without regard to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section) by the taxpayer in such succeeding taxable year to section 170(b)(1)(A) organizations,

(*b*) The charitable contributions of 30-percent capital gain property made to section 170(b)(1)(A) organizations in taxable years preceding the contribution year which, pursuant to the provisions of section 170 (b)(1)(D)(ii) and (d)(1) and this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year, and

(*c*) The charitable contributions, other than contributions of 30-percent capital gain property, made to section 170(b)(1)(A) organizations which, pursuant to the provisions of section 170(d)(1) and paragraph (b) of this section, are treated as having been paid to a section 170(b)(1)(A) organization in such succeeding year.

(iii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contribution of 30-percent capital gain property in the contribution year, computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section.

(iv) In the case of the second, third, fourth, and fifth succeeding taxable years succeeding the contribution year, the portion of the excess charitable contribution of 30-percent capital gain property in the contribution year (computed under subparagraph (1) of this paragraph and paragraph (d)(1) of this section) which has not been treated as paid to a section 170(b)(1)(A) organization in a year intervening between the contribution year and such succeeding taxable year.

For purposes of applying subdivisions (i) and (ii) of this subparagraph, the amount of charitable contributions of 30-percent capital gain property actually made in a taxable year succeeding the contribution year shall be determined by first applying the 30-percent limitation of section 170(b)(1)(D)(i) and paragraph (d) of §1.170A–8. If a taxpayer, in any one of the four taxable years succeeding a contribution year, elects under section 144 to take the standard deduction instead of itemizing the deductions allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in the standard deduction year the least of the amounts determined under subdivisions (i) to (iv), inclusive, of this subparagraph. The provisions of this subparagraph may be illustrated by the following example:

Example. Assume the following factual situation for C who itemizes his deductions in computing taxable income for each of the years set forth in the example:

	1970	1971	1972	1973	1974
Contribution base	$10,000	$15,000	$20,000	$15,000	$33,000
Contributions of cash to section 170(b)(1)(A) organizations	2,000	8,500	0	14,000	700
Contributions of 30-percent capital gain property to section 170(b)(1)(A) organizations	5,000	0	7,800	0	6,400

	1970	1971	1972	1973	1974
Allowable charitable contributions deductions (computed without regard to carryover of contributions) subject to limitations of:					
50 percent	2,000	7,500	0	7,500	700
30 percent	3,000	0	6,000	0	6,400
Total	5,000	7,500	6,000	7,500	7,100
Excess of contributions for taxable year to be treated as paid in 5 succeeding taxable years:					
Carryover of contributions of property other than 30-percent capital gain property	0	1,000	0	6,500	
Carryover of contributions of 30-percent capital gain property.	2,000	0	1,800	0	

C's excess contributions for 1970, 1971, 1972, and 1973 which are treated as having been paid to section 170(b)(1)(A) organizations in 1972, 1973, and 1974 are indicated below. The portion of the excess charitable contribution for 1972 of 30-percent capital gain property which is not treated as paid in 1974 ($1,800–$900) is available as a carryover to 1975.

1971

Contribution	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1971	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
1970	0	$2,000	0	0	$2,000
50 percent of C's contribution base for 1971				$7,500	
30 percent of C's contribution base for 1971					4,500
Less: Charitable contributions actually made in 1971 to section 170(b)(1)(A) organizations ($8,500, but not to exceed 50% of contribution base)				7,500	0
Excess				0	4,500
The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1971 is the least of:					
(i) Available carryover from 1970 to 1971 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1971 ($7,500) over sum of contributions actually made in 1971 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1971 ($4,500) over contributions of 30 percent capital gain property actually made in 1971 to section 170(b)(1)(A) organizations ($0)				4,500	
Amount treated as paid					0

1972

Contribution year	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	0	$1,000	0
				1,000	2,000
50 percent of C's contribution base for 1972				10,000	
30 percent of C's contribution base for 1972					6,000
Less: Charitable contributions actually made in 1972 to section 170(b)(1)(A) organizations ($7,800, but not to exceed 30% of contribution base)				0	6,000
Excess				10,000	0
(1) The amount of excess contributions for 1971 of property other than 30-percent capital gain property which is treated as paid in 1972 is the lesser of:					
(i) Available carryover from 1971 to 1972 of contributions of property other than 30-percent capital gain property				1,000	
(ii) Excess of 50 percent of contribution base for 1972 ($10,000) over contributions actually made in 1972 to section 170(b)(1)(A) organizations ($6,000)				4,000	
Amount treated as paid					1,000

1972

Contribution year	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
(2) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1972 is the least of:					
(i) Available carryover from 1970 to 1972 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1972 ($10,000) over sum of contributions actually made in 1972 to section 170(b)(1)(A) organizations ($6,000) and excess contributions for 1971 treated under item (1) above as paid in 1972 ($1,000)				3,000	
(iii) Excess of 30 percent of contribution base for 1972 ($6,000) over contributions of 30-percent capital gain property actually made in 1972 to section 170(b)(1)(A) organizations ($6,000)				0	
Amount treated as paid					0

1973

Contribution year	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1973	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	$1,000	0	0
1972	0	1,800	0	0	1,800
				0	3,800
50 percent of C's contribution base for 1973				$7,500	
30 percent of C's contribution base for 1973					4,500
Less: Charitable contributions actually made in 1973 to section 170(b)(1)(A) organizations ($14,000, but not to exceed 50% of contribution base)				7,500	0
Excess				0	4,500
(1) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1973 is the least of:					
(i) Available carryover from 1970 to 1973 of contributions of 30-percent capital gain property				2,000	
(ii) Excess of 50 percent of contribution base for 1973 ($7,500) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1973 ($4,500) over contributions of 30-percent capital gain property actually made in 1973 to section 170(b)(1)(A) organizations ($0)				4,500	
Amount treated as paid				0	
(2) The amount of excess contributions for 1972 of 30-percent capital gain property which is treated as paid in 1973 is the least of:					
(i) Available carryover from 1972 to 1973 of contributions of 30-percent capital gain property				1,800	
(ii) Excess of 50 percent of contribution base for 1973 ($7,500) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($7,500)				0	
(iii) Excess of 30 percent of contribution base for 1973 ($4,500) over sum of contributions of 30-percent capital gain property actually made in 1973 to section 170(b)(1)(A) organizations ($0) and excess contributions for 1970 treated under item (1) above as paid in 1973 ($0)				4,500	
Amount treated as paid				0	

1974

Contribution year	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1974	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
1970	0	$2,000	0	0	$2,000
1971	$1,000	0	$1,000	0	0
1972	0	1,800	0	0	1,800
1973	6,500	0	0	$6,500	0

1974

Contribution year	Total excess 50%	Total excess 30%	Less: Amount treated as paid in years prior to 1974	Available charitable contributions carryovers 50%	Available charitable contributions carryovers 30%
				6,500	3,800
50 percent of C's contribution base for 1974				16,500	....
30 percent of C's contribution base for 1974				....	9,900
Less: Charitable contributions actually made in 1974 to section 170(b)(1)(A) organizations				700	6,400
Excess				15,800	3,500
(1) The amount of excess contributions for 1973 of property other than 30-percent capital gain property which is treated as paid in 1974 is the lesser of:					
(i) Available carryover from 1973 to 1974 of contributions of property other than 30-percent capital gain property				6,500	....
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100)				9,400	....
Amount treated as paid				....	6,500
(2) The amount of excess contributions for 1970 of 30-percent capital gain property which is treated as paid in 1974 is the least of:					
(i) Available carryover from 1970 to 1974 of contributions of 30-percent capital gain property				$2,000	
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over sum of contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100) and excess contributions for 1973 of property other than 30-percent capital gain property treated under item (1) above as paid in 1974 ($6,500)				2,900	
(iii) Excess of 30 percent of contribution base for 1974 ($9,900) over contributions of 30-percent capital gain property actually made in 1974 to section 170(b)(1)(A) organizations ($6,400)				3,500	....
Amount treated as paid				....	$2,000
(3) The amount of excess contributions for 1972 of 30-percent capital gain property which is treated as paid in 1974 is the least of:					
(i) Available carryover from 1972 to 1974 of contributions of 30-percent capital gain property				1,800	
(ii) Excess of 50 percent of contribution base for 1974 ($16,500) over sum of contributions actually made in 1974 to section 170(b)(1)(A) organizations ($7,100) and excess contributions for 1973 and 1970 treated under items (1) and (2) above as paid in 1974 ($8,500)				900	
(iii) Excess of 30 percent of contribution base for 1974 ($9,900) over sum of contributions of 30-percent capital gain property actually made in 1974 to section 170(b)(1)(A) organizations ($6,400) and excess contributions for 1970 of 30-percent capital gain property treated under item (2) above as paid in 1974 ($2,000)				1,500	....
Amount treated as paid				....	900

(d) *Adjustments*—(1) *Effect of net operating loss carryovers on carryover of excess contributions*. An individual having a net operating loss carryover from a prior taxable year which is available as a deduction in a contribution year must apply the special rule of section 170(d)(1)(B) and this subparagraph in computing the excess described in paragraph (b)(1) or (c)(1) of this section for such contribution year. In determining the amount of excess charitable contributions that shall be treated as paid in each of the 5 taxable years succeeding the contribution year, the excess charitable contributions described in paragraph (b)(1) or (c)(1) of this section must be reduced by the amount by which such excess reduces taxable income (for purposes of determining the portion of a net operating loss which shall be carried to taxable years succeeding the contribution year under the second sentence of section 172(b)(2)) and increases the net operating loss which is carried to a succeeding taxable year. In reducing taxable income under the second sentence of section 172(b)(2), an individual who has made charitable contributions in the contribution year to both section 170(b)(1)(A) organizations, as defined in §1.170A–9, and to organizations which are not section 170(b)(1)(A) organizations must first deduct contributions made to the section 170(b)(1)(A) organizations from his adjusted gross income computed without regard to his net operating loss deduction before any of the contributions made to organizations which are not section 170(b)(1)(A) organizations may be deducted from such adjusted gross income. Thus, if the excess of the contributions made in the contribution year to section 170(b)(1)(A) organizations over the amount deductible in such contribution year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding year or years, no part of the excess charitable contributions made in such contribution year shall be treated as paid in any of the 5 immediately succeeding taxable years. If only a portion of the excess charitable contributions is so used, the excess charitable contributions shall be reduced only to that extent. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. B, an individual, reports his income on the calendar year basis and for the year 1970 has adjusted gross income (computed without regard to any net operating loss deduction) of $50,000. During 1970 he made charitable contributions of cash in the amount of $30,000 all of which were to section 170(b)(1)(A) organizations. B has a net operating loss carryover from 1969 of $50,000. In the absence of the net operating loss deduction B would have been allowed a deduction for charitable contributions of $25,000. After the application of the net operating loss deduction, B is allowed no deduction for charitable contributions, and there is (before applying the special rule of section 170(d)(1)(B) and this subparagraph) a tentative excess charitable contribution of $30,000. For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2) by deducting the $25,000 charitable contribution. After the $50,000 net operating loss carryover is applied against the $25,000 of taxable income for 1970 (computed in accordance with section 172(b)(2), assuming no deductions other than the charitable contributions deduction are applicable in making such computation), there remains a $25,000 net operating loss carryover to 1971. Since the application of the net operating loss carryover of $50,000 from 1969 reduces the 1970 adjusted gross income (for purposes of determining 1970 tax liability) to zero, no part of the $25,000 of charitable contributions in that year is deductible under section 170(b)(1). However, in determining the amount of the excess charitable contributions which shall be treated as paid in taxable years 1971, 1972, 1973, 1974, and 1975, the $30,000 must be reduced to $5,000 by the portion of the excess charitable contributions ($25,000) which was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover to 1971 from zero to $25,000.

Example 2. Assume the same facts as in *Example 1*, except that B's total charitable contributions of $30,000 in cash made during 1970 consisted of $25,000 to section 170(b)(1)(A) organizations and $5,000 to organizations other than section 170(b)(1)(A) organizations. Under these facts there is a tentative excess charitable contribution of $25,000, rather than $30,000 as in *Example 1*. For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2) by deducting the $25,000 of charitable contributions made to section 170(b)(1)(A) organizations. Since the excess charitable contribution of $25,000 determined in accordance with paragraph (b)(1) of this section was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1971 from zero to $25,000, no part of such excess charitable contributions made in the contribution year shall be treated as paid in any of the five immediately succeeding taxable years. No carryover is allowed with respect to the $5,000 of charitable contributions made in 1970 to organizations other than section 170(b)(1)(A) organizations.

Example 3. Assume the same facts as in *Example 1*, except that B's total contributions of $30,000 made during 1970 were of 30-percent capital gain property. Under these facts there is a tentative excess charitable contribution of $30,000. For purposes of determining the net operating loss which remains to be carried over to 1971, B computes his taxable income for 1970 under section 172(b)(2)(B) by deducting the $15,000 (30% of $50,000) contribution of 30-percent capital gain property which would have been deductible in 1970 absent the net operating loss deduction. Since $15,000 of the excess charitable contribution of $30,000 determined in accordance with paragraph (c)(1) of this section was used to reduce taxable income for 1970 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1971 from zero to $15,000, only $15,000 ($30,000—$15,000) of such excess shall be treated as paid in taxable years 1971, 1972, 1973, 1974, and 1975.

(2) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year computed as provided in paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. Thus, for example, assuming that in 1970 there is an excess contribution of $50,000 (determined as provided in paragraph (b)(1) of this section) which is to be carried to the 5 succeeding taxable years and that in 1973 the taxpayer has a net operating loss which may be carried back to 1970, the excess contribution of $50,000 for 1970 is not increased by reason of the fact that the adjusted gross income for 1970 (on which such excess contribution was based) is subsequently decreased by the carryback of the net operating loss from 1973. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of contributions made to section 170(b)(1)(A) organizations shall be limited to the amount of such contributions which did not exceed 50 percent or, in the case of 30-percent capital gain property, 30 percent of the donor's contribution base, computed without regard to any of the modifications referred to in section 172(d), for the contribution year. Thus, for example, assume that the taxpayer has a net operating loss in 1973 which is carried back to 1970 and in turn to 1971 and that he has made charitable contributions in 1970 to section 170(b)(1)(A) organizations. In determining the maximum amount of such charitable contributions which may be deducted in 1970 for purposes of determining the taxable income for 1970 which is deducted under section 172(b)(2) from the 1973 loss in order to ascertain the amount of such loss which is carried back to 1971, the 50-percent limitation of section 170(b)(1)(A) is based upon the adjusted gross income for 1970 computed without taking into account the net operating loss carryback from 1973 and without making any of the modifications specified in section 172(d).

(3) *Effect of net operating loss carryback to taxable years succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is treated as paid, as provided in paragraph (b)(2) or (c)(2) of this section, in a current taxable year (hereinafter referred to in this subparagraph as the ''deduction year'') shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any taxable year subsequent to the deduction year which is a carryback or carryover to taxable years succeeding the deduction year, the amount of contributions made to section 170(b)(1)(A) organizations in the deduction year shall be limited to the amount of such contributions, which were actually made in such year and those which were treated as paid in such year, which did not exceed 50 percent or, in the case of 30-percent capital gain property, 30 percent of the donor's contribution base, computed without regard to any of the modifications referred to in section 172(d), for the deduction year.

(4) *Husband and wife filing joint returns*—(i) *Change from joint return to separate returns.* If a husband and wife:

(*a*) Make a joint return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph, and

(*b*) Make separate returns for one or more of the 5 taxable years immediately succeeding such contribution year, any excess charitable contribution for the contribution year which is unused at the beginning of the first such taxable year for which separate returns are filed shall be allocated between the husband and wife. For purposes of the allocation, a computation shall be made of the amount of any excess charitable contribution which each spouse would have computed in accordance with paragraph (b)(1) or (c)(1) of this section and subparagraph

(1) of this paragraph if separate returns (rather than a joint return) had been filed for the contribution year. The portion of the total unused excess charitable contribution for the contribution year allocated to each spouse shall be an amount which bears the same ratio to such unused excess charitable contribution as such spouse's excess contribution, based on the separate return computation, bears to the total excess contributions of both spouses, based on the separate return computation. To the extent that a portion of the amount allocated to either spouse in accordance with the foregoing provisions of this subdivision is not treated in accordance with the provisions of paragraph (b)(2) or (c)(2) of this section as a charitable contribution paid to a section 170(b)(1)(A) organization in the taxable year in which a separate return or separate returns are filed, each spouse shall for purposes of paragraph (b)(2) or (c)(2) of this section treat his respective unused portion as the available charitable contributions carryover to the next succeeding taxable year in which the joint excess charitable contribution may be treated as paid in accordance with paragraph (b)(1) or (c)(1) of this section. If such husband and wife make a joint return in one of the 5 taxable years immediately succeeding the contribution year with respect to which a joint excess charitable contribution is computed and following such first taxable year for which such husband and wife filed a separate return, the amounts allocated to each spouse in accordance with this subdivision for such first year reduced by the portion of such amounts treated as paid to a section 170(b)(1)(A) organization in such first year and in any taxable year intervening between such first year and the succeeding taxable year in which the joint return is filed shall be aggregated for purposes of determining the amount of the available charitable contributions carryover to such succeeding taxable year. The provisions of this subdivision may be illustrated by the following example:

Example. (a) H and W file joint returns for 1970, 1971, and 1972, and in 1973 they file separate returns. In each such year H and W itemize their deductions in computing taxable income. Assume the following factual situation with respect to H and W for 1970:

1970

	H	W	Joint return
Contribution base	$50,000	$40,000	$90,000
Contributions of cash to section 170(b)(1)(A) organizations (no other contributions)	37,000	28,000	65,000
Allowable charitable contributions deductions	25,000	20,000	45,000
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	12,000	8,000	20,000

(b) The joint excess charitable contribution of $20,000 is to be treated as having been paid to a section 170(b)(1)(A) organization in the 5 succeeding taxable years. Assume that in 1971 the portion of such excess treated as paid by H and W is $3,000, and that in 1972 the portion of such excess treated as paid is $7,000. Thus, the unused portion of the excess charitable contribution made in the contribution year is $10,000 ($20,000 less $3,000 [amount treated as paid in 1971] and $7,000 [amount treated as paid in 1972]). Since H and W file separate returns in 1973, $6,000 of such $10,000 is allocable to H, and $4,000 is allocable to W. Such allocation is computed as follows:

$12,000 (excess charitable contributions made by H (based on separate return computation) in 1970)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1970) × $10,000 = $6,000

$8,000 (excess charitable contributions made by W (based on separate return computation) in 1970)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1970) × $10,000 = $4,000

(c) In 1973 H has a contribution base of $70,000, and he contributes $14,000 in cash to a section 170(b)(1)(A) organization. In 1973 W has a contribution base of $50,000, and she contributes $10,000 in cash to a section 170(b)(1)(A) organization. Accordingly, H may claim a charitable contributions deduction of $20,000 in 1973, and W may claim a charitable contributions deduction of $14,000 in 1973. H's $20,000 deduction consists of the $14,000 contribution made to the section 170(b)(1)(A) organization in 1973 and the $6,000 carried over from 1970 and treated as a charitable contribution paid by him to a section 170(b)(1)(A) organization in 1973. W's $14,000 deduction consists of the $10,000 contribution made to a section 170(b)(1)(A) organization in 1973 and the $4,000 carried over from 1970 and treated as a charitable contribution paid by her to a section 170(b)(1)(A) organization in 1973.

(d) The $6,000 contribution treated as paid in 1973 by H, and the $4,000 contribution treated as paid in 1973 by W, are computed as follows:

	H	W
Available charitable contribution carryover (see computations in (b))	$6,000	$4,000
50 percent of contribution base	35,000	25,000
Contributions of cash made in 1973 to section 170(b)(1)(A) organizations (no other contributions)	14,000	10,000
	21,000	15,000
Amount of excess contributions treated as paid in 1973: The lesser of $6,000 (available carryover of H to 1973) or $21,000 (excess of 50 percent of contribution base ($35,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($14,000))	$6,000	
The lesser of $4,000 (available carryover of W to 1973) or $15,000 (excess of 50 percent of contribution base ($25,000) over contributions actually made in 1973 to section 170(b)(1)(A) organizations ($10,000))	....	$4,000

(e) It is assumed that H and W made no contributions of 30-percent capital gain property during these years. If they had made such contributions, there would have been similar adjustments based on 30 percent of the contribution base.

(ii) *Change from separate returns to joint return.* If in the case of a husband and wife:

(*a*) Either or both of the spouses make a separate return for a contribution year and compute an excess charitable contribution for such year in accordance with the provisions of paragraph (b)(1) or (c)(1) of this section and subparagraph (1) of this paragraph, and

(*b*) Such husband and wife make a joint return for one or more of the taxable years succeeding such contribution year, the excess charitable contribution of the husband and wife for the contribution year which is unused at the beginning of the first taxable year for which a joint return is filed shall be aggregated for purposes of determining the portion of such unused charitable contribution which shall be treated in accordance with paragraph (b)(2) or (c)(2) of this section as a charitable contribution paid to a section 170(b)(1)(A) organization. The provisions of this subdivision also apply in the case of two single individuals who are subsequently married and file a joint return. A remarried taxpayer who filed a joint return with a former spouse in a contribution year with respect to which an excess charitable contribution was computed and who in any one of the 5 taxable years succeeding such contribution year files a joint return with his or her present spouse shall treat the unused portion of such excess charitable contribution allocated to him or her in accordance with subdivision (i) of this subparagraph in the same manner as the unused portion of an excess charitable contribution computed in a contribution year in which he filed a separate return, for purposes of determining the amount which in accordance with paragraph (b)(2) or (c)(2) of this section shall be treated as paid to an organization specified in section 170(b)(1)(A) in such succeeding year.

(iii) *Unused excess charitable contribution of deceased spouse.* In case of the death of one spouse, any unused portion of an excess charitable contribution which is allocable in accordance with subdivision (i) of this subparagraph to such spouse shall not be treated as paid in the taxable year in which such death occurs or in any subsequent taxable year except on a separate return made for the deceased spouse by a fiduciary for the taxable year which ends with the date of death or on a joint return for the taxable year in which such death occurs. The application of this subdivision may be illustrated by the following example:

Example. Assume the same facts as in the example in subdivision (i) of this subparagraph except that H dies in 1972 and W files a separate return for 1973. W made a joint return for herself and H for 1972. In the example, the unused excess charitable contribution as of January 1, 1973, was $10,000, $6,000 of which was allocable to H and $4,000 to W. No portion of the $6,000 allocable to H may be treated as paid by W or any other person in 1973 or any subsequent year.

(e) *Information required in support of a deduction of an amount carried over and treated as paid.* If, in a taxable year, a deduction is claimed in respect of an excess charitable contribution which, in accordance with the provisions of paragraph (b)(2) or (c)(2) of this section, is treated (in whole or in part) as paid in such taxable year, the taxpayer shall attach to his return a statement showing:

(1) The contribution year (or years) in which the excess charitable contributions were made,

(2) The excess charitable contributions made in each contribution year, and the amount of such excess charitable contributions consisting of 30-percent capital gain property,

(3) The portion of such excess, or of each such excess, treated as paid in accordance with paragraph (b)(2) or (c)(2) of this section in any taxable year intervening between the contribution year and the taxable year for which the return is made, and the portion of such excess which consists of 30-percent capital gain property.

(4) Whether or not an election under section 170(b)(1)(D)(iii) has been made which affects any of such excess contributions of 30-percent capital gain property, and

(5) Such other information as the return or the instructions relating thereto may require.

(f) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969. For purposes of applying section 170(d)(1) with respect to contributions paid in a taxable year beginning before January 1, 1970, subsection (b)(1)(D), subsection (e), and paragraphs (1), (2), (3), and (4) of subsection (f) of section 170 shall not apply. See section 201(g)(1)(D) of the Tax Reform Act of 1969 (83 Stat. 564).

[T.D. 7207, 37 FR 20787, Oct. 4, 1972; 37 FR 22982, Oct. 27, 1972, as amended by T.D. 7340, 40 FR 1240, Jan. 7, 1975]

§ 1.170A–11 Limitation on, and carryover of, contributions by corporations.

(a) *In general.* The deduction by a corporation in any taxable year for charitable contributions, as defined in section 170(c), is limited to 5 percent of its taxable income for the year, computed without regard to:

(1) The deduction under section 170 for charitable contributions,

(2) The special deductions for corporations allowed under Part VIII (except section 248), Subchapter B, Chapter 1 of the Code,

(3) Any net operating loss carryback to the taxable year under section 172, and

(4) Any capital loss carryback to the taxable year under section 1212(a)(1).

A charitable contribution by a corporation to a trust, chest, fund, or foundation described in section 170(c)(2) is deductible under section 170 only if the contribution is to be used in the United States or its possessions exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals. For the purposes of section 170, amounts excluded from the gross income of a corporation under section 114, relating to sports programs conducted for the American National Red Cross, are not to be considered contributions or gifts.

(b) *Election by corporations on an accrual method.* (1) A corporation reporting its taxable income on an accrual method may elect to have a charitable contribution treated as paid during the taxable year, if payment is actually made on or before the 15th day of the third month following the close of such year and if, during such year, its board of directors authorizes the charitable contribution. If by reason of such an election a charitable contribution (other than a contribution of a letter, memorandum, or property similar to a letter or memorandum) paid in a taxable year beginning after December 31, 1969, is treated as paid during a taxable year beginning before January 1, 1970, the provisions of § 1.170A–4 shall not be applied to reduce the amount of such contribution. However, see section 170(e) before its amendment by the Tax Reform Act of 1969.

(2) The election must be made at the time the return for the taxable year is filed, by reporting the contribution on the return. There shall be attached to the return when filed a written declaration stating that the resolution authorizing the contribution was adopted by the board of directors during the taxable year. For taxable years beginning before January 1, 2003, the declaration shall be verified by a statement signed by an officer authorized to sign the return that it is made under

penalties of perjury, and there shall also be attached to the return when filed a copy of the resolution of the board of directors authorizing the contribution. For taxable years beginning after December 31, 2002, the declaration must also include the date of the resolution, the declaration shall be verified by signing the return, and a copy of the resolution of the board of directors authorizing the contribution is a record that the taxpayer must retain and keep available for inspection in the manner required by §1.6001–1(e).

(c) *Charitable contributions carryover of corporations*—(1) *In general.* Subject to the reduction provided in subparagraph (2) of this paragraph, any charitable contributions made by a corporation in a taxable year (hereinafter in this paragraph referred to as the ''contribution year'') in excess of the amount deductible in such contribution year under the 5-percent limitation of section 170(b)(2) are deductible in each of the five succeeding taxable years in order of time, but only to the extent of the lesser of the following amounts:

(i) The excess of the maximum amount deductible for such succeeding taxable year under the 5-percent limitation of section 170(b)(2) over the sum of the charitable contributions made in that year plus the aggregate of the excess contributions which were made in taxable years before the contribution year and which are deductible under this paragraph in such succeeding taxable year; or

(ii) In the case of the first taxable year succeeding the contribution year, the amount of the excess charitable contributions, and in the case of the second, third, fourth, and fifth taxable years succeeding the contribution year, the portion of the excess charitable contributions not deductible under this subparagraph for any taxable year intervening between the contribution year and such succeeding taxable year.

This paragraph applies to excess charitable contributions by a corporation, whether or not such contributions are made to, or for the use of, the donee organization and whether or not such organization is a section 170(b)(1)(A) organization, as defined in §1.170A–9. For purposes of applying this paragraph, a charitable contribution made in a taxable year beginning before January 1, 1970, which is carried over to taxable year beginning after December 31, 1969, under section 170(b)(2) (before its amendment by the Tax Reform Act of 1969) and is deductible in such taxable year beginning after December 31, 1969, shall be treated as deductible under section 170(d)(1) and this paragraph. The application of this subparagraph may be illustrated by the following example:

Example. A corporation which reports its income on the calendar year basis makes a charitable contribution of $20,000 in 1970. Its taxable income (determined without regard to any deduction for charitable contributions) for 1970 is $100,000. Accordingly, the charitable contributions deduction for that year is limited to $5,000 (5 percent of $100,000). The excess charitable contribution not deductible in 1970 ($15,000) is a carryover to 1971. The corporation has taxable income (determined without regard to any deduction for charitable contributions) of $150,000 in 1971 and makes a charitable contribution of $5,000 in that year. For 1971 the corporation may deduct as a charitable contribution the amount of $7,500 (5 percent of $150,000). This amount consists of the $5,000 contribution made in 1971 and of the $2,500 carried over from 1970. The remaining $12,500 carried over from 1970 and not allowable as a deduction for 1971 because of the 5-percent limitation may be carried over to 1972. The corporation has taxable income (determined without regard to any deduction for charitable contributions) of $200,000 in 1972 and makes a charitable contribution of $5,000 in that year. For 1972 the corporation may deduct the amount of $10,000 (5 percent of $200,000). This amount consists of the $5,000 contributed in 1972, and $5,000 of the $12,500 carried over from 1970 to 1972. The remaining $7,500 of the carryover from 1970 is available for purposes of computing the charitable contributions carryover from 1970 to 1973, 1974, and 1975.

(2) *Effect of net operating loss carryovers on carryover of excess contributions.* A corporation having a net operating loss carryover from any taxable year must apply the special rule of section 170(d)(2)(B) and this subparagraph before computing under subparagraph (1) of this paragraph the excess charitable contributions carryover from any taxable year. In determining the amount of excess charitable contributions that may be deducted in accordance with subparagraph (1) of this paragraph in taxable years succeeding

the contribution year, the excess of the charitable contributions made by a corporation in the contributions year over the amount deductible in such year must be reduced by the amount by which such excess reduces taxable income for purposes of determining the net operating loss carryover under the second sentence of section 172(b)(2)) and increases a net operating loss carryover to a succeeding taxable year. Thus, if the excess of the contributions made in a taxable year over the amount deductible in the taxable year is utilized to reduce taxable income (under the provisions of section 172(b)(2)) for such year, thereby serving to increase the amount of the net operating loss carryover to a succeeding taxable year or years, no charitable contributions carryover will be allowed. If only a portion of the excess charitable contributions is so used, the charitable contributions carryover will be reduced only to that extent. The application of this subparagraph may be illustrated by the following example:

Example. A corporation, which reports its income on the calendar year basis, makes a charitable contribution of $10,000 during 1971. Its taxable income for 1971 is $80,000 (computed without regard to any net operating loss deduction and computed in accordance with section 170(b)(2) without regard to any deduction for charitable contributions). The corporation has a net operating loss carryover from 1970 of $80,000. In the absence of the net operating loss deduction the corporation would have been allowed a deduction for charitable contributions of $4,000 (5 percent of $80,000). After the application of the net operating loss deduction the corporation is allowed no deduction for charitable contributions, and there is a tentative charitable contribution carryover from 1971 of $10,000. For purposes of determining the net operating loss carryover to 1972 the corporation computes its taxable income for 1971 under section 172(b)(2) by deducting the $4,000 charitable contribution. Thus, after the $80,000 net operating loss carryover is applied against the $76,000 of taxable income for 1971 (computed in accordance with section 172(b)(2)), there remains a $4,000 net operating loss carryover to 1972. Since the application of the net operating loss carryover of $80,000 from 1970 reduces the taxable income for 1971 to zero, no part of the $10,000 of charitable contributions in that year is deductible under section 170(b)(2). However, in determining the amount of the allowable charitable contributions carryover from 1971 to 1972, 1973, 1974, 1975, and 1976, the $10,000 must be reduced by the portion thereof ($4,000) which was used to reduce taxable income for 1971 (as computed for purposes of the second sentence of section 172(b)(2)) and which thereby served to increase the net operating loss carryover from 1970 to 1972 from zero to $4,000.

(3) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year computed as provided in subparagraph (1) of this paragraph shall not be increased because a net operating loss carryback is available as a deduction in the contribution year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any year subsequent to the contribution year which is a carryback or carryover to taxable years succeeding the contribution year, the amount of any charitable contributions shall be limited to the amount of such contributions which did not exceed 5 percent of the donor's taxable income, computed as provided in paragraph (a) of this section and without regard to any of the modifications referred to in section 172(d), for the contribution year. For illustrations see paragraph (d)(2) of §1.170A–10.

(4) *Effect of net operating loss carryback to taxable year succeeding the contribution year.* The amount of the charitable contribution from a preceding taxable year which is deductible (as provided in this paragraph) in a current taxable year (hereinafter referred to in this subparagraph as the "deduction year") shall not be reduced because a net operating loss carryback is available as a deduction in the deduction year. In addition, in determining under the provisions of section 172(b)(2) the amount of the net operating loss for any taxable year subsequent to the deduction year which is a carryback or a carryover to taxable years succeeding the deduction year, the amount of contributions made in the deduction year shall be limited to the amount of such contributions, which were actually made in such year and those which were deductible in such year under section 170(d)(2), which did not exceed 5 percent of the donor's taxable income, computed as provided in paragraph (a) of this section and

without regard to any of the modifications referred to in section 172(d), for the deduction year.

(5) *Year contribution is made.* For purposes of this paragraph, contributions made by a corporation in a contribution year include contributions which, in accordance with the provisions of section 170(a)(2) and paragraph (b) of this section, are considered as paid during such contribution year.

(d) *Effective date.* This section applies only to contributions paid in taxable years beginning after December 31, 1969. For purposes of applying section 170(d)(2) with respect to contributions paid, or treated under section 170(a)(2) as paid, in a taxable year beginning before January 1, 1970, subsection (e), and paragraphs (1), (2), (3), and (4) of subsection (f) of section 170 shall not apply. See section 201(g)(1)(D) of the Tax Reform Act of 1969 (83 Stat. 564).

[T.D. 7207, 37 FR 20793, Oct. 4, 1972, as amended by T.D. 7807, 47 FR 4512, Feb. 1, 1982; T.D. 9100, 68 FR 70704, Dec. 19, 2003; T.D. 9300, 71 FR 71041, Dec. 8, 2006]

§ 1.170A–12 Valuation of a remainder interest in real property for contributions made after July 31, 1969.

(a) *In general.* (1) Section 170(f)(4) provides that, in determining the value of a remainder interest in real property for purposes of section 170, depreciation and depletion of such property shall be taken into account. Depreciation shall be computed by the straight line method and depletion shall be computed by the cost depletion method. Section 170(f)(4) and this section apply only in the case of a contribution, not made in trust, of a remainder interest in real property made after July 31, 1969, for which a deduction is otherwise allowable under section 170.

(2) In the case of the contribution of a remainder interest in real property consisting of a combination of both depreciable and nondepreciable property, or of both depletable and nondepletable property, and allocation of the fair market value of the property at the time of the contribution shall be made between the depreciable and nondepreciable property, or the depletable and nondepletable property, and depreciation or depletion shall be taken into account only with respect to the depreciable or depletable property. The expected value at the end of its ''estimated useful life'' (as defined in paragraph (d) of this section) of that part of the remainder interest consisting of depreciable property shall be considered to be nondepreciable property for purposes of the required allocation. In the case of the contribution of a remainder interest in stock in a cooperative housing corporation (as defined in section 216(b)(1)), an allocation of the fair market value of the stock at the time of the contribution shall be made to reflect the respective values of the depreciable and nondepreciable property underlying such stock, and depreciation on the depreciable part shall be taken into account for purposes of valuing the remainder interest in such stock.

(3) If the remainder interest that has been contributed follows only one life, the value of the remainder interest shall be computed under the rules contained in paragraph (b) of this section. If the remainder interest that has been contributed follows a term for years, the value of the remainder interest shall be computed under the rules contained in paragraph (c) of this section. If the remainder interest that has been contributed is dependent upon the continuation or the termination of more than one life or upon a term certain concurrent with one or more lives, the provisions of paragraph (e) of this section shall apply. In every case where it is provided in this section that the rules contained in § 25.2512–5 (or, for certain prior periods, § 25.2512–5A) of this chapter (Gift Tax Regulations) apply, such rules shall apply notwithstanding the general effective date for such rules contained in paragraph (a) of such section. Except as provided in § 1.7520–3(b) of this chapter, for transfers of remainder interests after April 30, 1989, the present value of the remainder interest is determined under § 25.2512–5 of this chapter by use of the interest rate component on the date the interest is transferred unless an election is made under section 7520 and § 1.7520–2 of this chapter to compute the present value of the interest transferred by use of the interest rate component for either of the 2 months preceding the month in which the interest

is transferred. In some cases, a reduction in the amount of a charitable contribution of a remainder interest, after the computation of its value under section 170(f)(4) and this section, may be required. See section 170(e) and § 1.170A–4.

(b) *Valuation of a remainder interest following only one life*—(1) *General rule.* The value of a remainder interest in real property following only one life is determined under the rules provided in § 20.2031–7 (or for certain prior periods, § 20.2031–7A) of this chapter (Estate Tax Regulations), using the interest rate and life contingencies prescribed for the date of the gift. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). However, if any part of the real property is subject to exhaustion, wear and tear, or obsolescence, the special factor determined under paragraph (b)(2) of this section shall be used in valuing the remainder interest in that part. Further, if any part of the property is subject to depletion of its natural resources, such depletion is taken into account in determining the value of the remainder interest.

(2) *Computation of depreciation factor.* If the valuation of the remainder interest in depreciable property is dependent upon the continuation of one life, a special factor must be used. The factor determined under this paragraph (b)(2) is carried to the fifth decimal place. The special factor is to be computed on the basis of the interest rate and life contingency rates from the mortality table prescribed in § 20.2031–7 of this chapter (or for periods before June 1, 2023, §§ 20.2031–7(d)(3) and 20.2031–7A of this chapter) and on the assumption that the property depreciates on a straight-line basis over its estimated useful life. For transfers for which the valuation date is on or after June 1, 2023, special factors for determining the present value of a remainder interest following one life may be computed by taxpayers based on Table 2010CM, found in § 20.2031–7(d)(7)(ii) of this chapter, and using the formula provided in this paragraph (b)(2). Alternatively, taxpayers may use the actuarial factors provided in Table C to determine the special factor for the remainder interest following one life. Table C currently is available, at no charge, electronically via the IRS website at *https://www.irs.gov/retirement-plans/actuarial-tables* (or a corresponding URL as may be updated from time to time). IRS Publication 1459, *Actuarial Valuations Version 4C* (2023), references and explains Table C and provides examples describing the computation. This publication will be available within a reasonable time after June 1, 2023. For transfers for which the valuation date is on or after May 1, 2009, and before June 1, 2023, special factors for determining the present value of a remainder interest following one life and an example describing the computation are contained in the previous version of Table C, which currently is available, at no charge, electronically via the IRS website at *https://www.irs.gov/retirement-plans/actuarial-tables*. IRS Publication 1459, *Actuarial Valuations Version 3C* (2009), references and explains this version of Table C and provides examples describing the computation. See, however, § 1.7520–3(b) (relating to exceptions to the use of prescribed tables under certain circumstances). Otherwise, in the case of the valuation of a remainder interest following one life, the special factor may be obtained through use of the formula in Figure 1 to this paragraph (b)(2). The prescribed mortality table is Table 2010CM as set forth in § 20.2031–7(d)(7)(ii) of this chapter, or for periods before June 1, 2023, the appropriate table found in § 20.2031–7A of this chapter. Table 2010CM is referenced by IRS Publication 1459, *Actuarial Values Version 4C*. The mortality tables prescribed for periods before June 1, 2023, are referenced by prior versions of IRS Publication 1459.

FIGURE 1 TO PARAGRAPH (B)(2)—FORMULA FOR DETERMINING SINGLE LIFE REMAINDER INTEREST IN DEPRECIABLE PROPERTY

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} v^{t+1}\left({}_{t+1}q_x - {}_{t}q_x\right)\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

where:

n = the estimated number of years of useful life;

i = the applicable interest rate under section 7520 of the Internal Revenue Code;

v = 1 / (1 + i) ;

$${}_{t}q_x = 1 - \frac{l_{x+t}}{l_x} \quad ;$$

x = the age of the measuring life (determined as age at nearest birthday); and

l_x = the number associated with age x as set forth in the prescribed mortality table, representing the number of persons alive at age x.

(3) *Sample factors from actuarial Table S*. The present value of a remainder interest dependent on the termination of one life is determined by using the formula in § 20.2031–7(d)(2)(ii)(B) of this chapter to derive a remainder factor expressed to at least five decimal places. For the convenience of taxpayers, actuarial factors have been computed by the IRS and appear in Table S. The complete Table S can be found on the IRS website at *https://www.irs.gov/retirement-plans/actuarial-tables*. For purposes of the example in paragraph (b)(4) of this section, the following factors from Table S will be used:

TABLE 1 TO PARAGRAPH (b)(3)

Age	Annuity	Life estate	Remainder
Factors from Table S—Based on Table 2010CM			
Interest at 3.2 Percent			
62	14.6131	0.46762	0.53238

(4) *Example*. After June 1, 2023, A, who is 62, donates to Y University a remainder interest in a personal residence, consisting of a house and land, subject to a reserved life estate in A. At the time of the gift, the land has a value of $30,000 and the house has a value of $100,000 with an estimated useful life of 28 years, at the end of which period the value of the house is expected to be $10,000. The portion of the property considered to be depreciable is $90,000 (the value of the house ($100,000) less its expected value at the end of 28 years ($10,000)). The portion of the property considered to be nondepreciable is $40,000 (the value of the land at the time of the gift ($30,000) plus the expected value of the house at the end of 28 years ($10,000)). A chooses to use the interest rate prescribed under section 7520 for the month in which the gift was made (3.2 percent). Based on an interest rate of 3.2 percent, the remainder factor for $1.00 prescribed in § 20.2031–7(d) and found in Table S for a person age 62 is 0.53238. The value of the nondepreciable remainder interest

is $21,295.20 (0.53238 times $40,000). The factor for the remainder interest in depreciable property is computed under the formula described in paragraph (b)(2) of this section and is 0.19392. (This factor, 0.19392, may instead be determined by using Table C, which can be found on the IRS website at *https://www.irs.gov/retirement-plans/actuarial-tables*, and following the method provided in IRS Publication 1459, *Actuarial Values Version 4C*.) The value of the depreciable remainder interest is $17,452.80 (0.19392 times $90,000). Therefore, the value of the remainder interest is $38,748.00 ($21,295.20 plus $17,452.80).

(c) *Valuation of a remainder interest following a term for years.* The value of a remainder interest in real property following a term for years shall be determined under the rules provided in §25.2512–5 (or, for certain prior periods, §25.2512–5A) of this chapter (Gift Tax Regulations) using Table B provided in §20.2031–7(d)(6) of this chapter. However, if any part of the real property is subject to exhaustion, wear and tear, or obsolescence, in valuing the remainder interest in that part the value of such part is adjusted by subtracting from the value of such part the amount determined by multiplying such value by a fraction, the numerator of which is the number of years in the term or, if less, the estimated useful life of the property, and the denominator of which is the estimated useful life of the property. The resultant figure is the value of the property to be used in §25.2512–5 (or, for certain prior periods, §25.2512–5A) of this chapter (Gift Tax Regulations). Further, if any part of the property is subject to depletion of its natural resources, such depletion shall be taken into account in determining the value of the remainder interest. The provisions of this paragraph as it relates to depreciation are illustrated by the following example:

Example. In 1972, B donates to Z University a remainder interest in his personal residence, consisting of a house and land, subject to a 20 year term interest provided for his sister. At such time the house has a value of $60,000, and an expected useful life of 45 years, at the end of which time it is expected to have a value of $10,000, and the land has a value of $8,000. The value of the portion of the property considered to be depreciable is $50,000 (the value of the house ($60,000) less its expected value at the end of 45 years ($10,000)), and this is multiplied by the fraction 20/45. The product, $22,222.22, is subtracted from $68,000, the value of the entire property, and the balance, $45,777.78, is multiplied by the factor .311805 (see §25.2512–5A(c)). The result, $14,273.74, is the value of the remainder interest in the property.

(d) *Definition of estimated useful life.* For the purposes of this section, the determination of the estimated useful life of depreciable property shall take account of the expected use of such property during the period of the life estate or term for years. The term ''estimated useful life'' means the estimated period (beginning with the date of the contribution) over which such property may reasonably be expected to be useful for such expected use. This period shall be determined by reference to the experience based on any prior use of the property for such purposes if such prior experience is adequate. If such prior experience is inadequate or if the property has not been previously used for such purposes, the estimated useful life shall be determined by reference to the general experience of persons normally holding similar property for such expected use, taking into account present conditions and probable future developments. The estimated useful life of such depreciable property is not limited to the period of the life estate or term for years preceding the remainder interest. In determining the expected use and the estimated useful life of the property, consideration is to be given to the provisions of the governing instrument creating the life estate or term for years or applicable local law, if any, relating to use, preservation, and maintenance of the property during the life estate or term for years. In arriving at the estimated useful life of the property, estimates, if available, of engineers or other persons skilled in estimating the useful life of similar property may be taken into account. At the option of the taxpayer, the estimated useful life of property contributed after December 31, 1970, for purposes of this section, shall be an asset depreciation period selected by the taxpayer that is within the permissible asset depreciation range for the relevant asset guideline class established pursuant to §1.167(a)–11(b) (4)(ii).

For purposes of the preceding sentence, such period, range, and class shall be those which are in effect at the time that the contribution of the remainder interest was made. At the option of the taxpayer, in the case of property contributed before January 1, 1971, the estimated useful life, for purposes of this section, shall be the guideline life provided in Revenue Procedure 62–21 for the relevant asset guideline class.

(e) *Valuation of a remainder interest following more than one life or a term certain concurrent with one or more lives.* (1)(i) If the valuation of the remainder interest in the real property is dependent upon the continuation or the termination of more than one life or upon a term certain concurrent with one or more lives, a special factor must be used.

(ii) The special factor is to be computed on the basis of—

(A) Interest at the rate prescribed under §25.2512–5 (or, for certain prior periods, §25.2512–5A) of this chapter, compounded annually;

(B) Life contingencies determined from the values that are set forth in the mortality table in §20.2031–7 (or, for certain prior periods, §20.2031–7A) of this chapter; and

(C) If depreciation is involved, the assumption that the property depreciates on a straight-line basis over its estimated useful life.

(iii) If any part of the property is subject to depletion of its natural resources, such depletion must be taken into account in determining the value of the remainder interest.

(2) In the case of the valuation of a remainder interest following two lives, the special factor may be obtained through use of the formula in Figure 2 to this paragraph (e)(2). The prescribed mortality table is Table 2010CM as set forth in §20.2031–7(d)(7)(ii) of this chapter, or for periods before June 1, 2023, the appropriate table found in §20.2031–7A of this chapter. Table 2010CM is referenced by IRS Publication 1459, *Actuarial Values Version 4C*. The mortality tables prescribed for periods before June 1, 2023, are referenced by prior versions of IRS Publication 1459.

FIGURE 2 TO PARAGRAPH (E)(2)—FORMULA FOR DETERMINING TWO-LIFE REMAINDER INTEREST IN DEPRECIABLE PROPERTY

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} v^{t+1}\left({}_{t+1}q_x \cdot {}_{t+1}q_y - {}_{t}q_x \cdot {}_{t}q_y\right)\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

where:

n = the estimated number of years of useful life;

i = the applicable interest rate under section 7520 of the Internal Revenue Code;

v = 1 / (1 + i) ;

$${}_{t}q_x = 1-\frac{l_{x+t}}{l_x} \;;$$

x and y are the ages of the measuring lives (determined as age at nearest birthday); and

l_x = the number associated with age x as set forth in the prescribed mortality table, representing the number of persons alive at age x.

(3) Notwithstanding that the taxpayer may be able to compute the special factor in certain cases under paragraph (2), if a special factor is required in the case of an actual contribution,

the Commissioner will furnish the factor to the donor upon request. The request must be accompanied by a statement of the sex and date of birth of each person the duration of whose life may affect the value of the remainder interest, copies of the relevant instruments, and, if depreciation is involved, a statement of the estimated useful life of the depreciable property. However, since remainder interests in that part of any property which is depletable cannot be valued on a purely actuarial basis, special factors will not be furnished with respect to such part. Requests should be forwarded to the Commissioner of Internal Revenue, Attention: OP:E:EP:A:1, Washington, DC 20224.

(f) *Applicability date.* This section applies to contributions made after July 31, 1969, except that paragraphs (b)(2), (3), and (4) and (e)(2) of this section apply to all contributions made on or after June 1, 2023.

[T.D. 7370, 40 FR 34337, Aug. 15, 1975, as amended by T.D. 7955, 49 FR 19975, May 11, 1984; T.D. 8540, 59 FR 30102, 30104, June 10, 1994; T.D. 8819, 64 FR 23228, Apr. 30, 1999; T.D. 8886, 65 FR 36909, 36943, June 12, 2000; T.D. 9448, 74 FR 21439, 21518, May 7, 2009; 74 FR 27079, June 8, 2009; T.D. 9540, 76 FR 49571, 49612, Aug. 10, 2011; T.D. 9974, 88 FR 37427, June 7, 2023]

§ 1.170A–13 Recordkeeping and return requirements for deductions for charitable contributions.

(a) *Charitable contributions of money made in taxable years beginning after December 31, 1982*—(1) *In general.* If a taxpayer makes a charitable contribution of money in a taxable year beginning after December 31, 1982, the taxpayer shall maintain for each contribution one of the following:

(i) A cancelled check.

(ii) A receipt from the donee charitable organization showing the name of the donee, the date of the contribution, and the amount of the contribution. A letter or other communication from the donee charitable organization acknowledging receipt of a contribution and showing the date and amount of the contribution constitutes a receipt for purposes of this paragraph (a).

(iii) In the absence of a canceled check or receipt from the donee charitable organization, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution.

(2) *Special rules*—(i) *Reliability of records.* The reliability of the written records described in paragraph (a)(1)(iii) of this section is to be determined on the basis of all of the facts and circumstances of a particular case. In all events, however, the burden shall be on the taxpayer to establish reliability. Factors indicating that the written records are reliable include, but are not limited to:

(A) The contemporaneous nature of the writing evidencing the contribution.

(B) The regularity of the taxpayer's recordkeeping procedures. For example, a contemporaneous diary entry stating the amount and date of the donation and the name of the donee charitable organization made by a taxpayer who regularly makes such diary entries would generally be considered reliable.

(C) In the case of a contribution of a small amount, the existence of any written or other evidence from the donee charitable organization evidencing receipt of a donation that would not otherwise constitute a receipt under paragraph (a)(1)(ii) of this section (including an emblem, button, or other token traditionally associated with a charitable organization and regularly given by the organization to persons making cash donations).

(ii) *Information stated in income tax return.* The information required by paragraph (a)(1)(iii) of this section shall be stated in the taxpayer's income tax return if required by the return form or its instructions.

(3) *Taxpayer option to apply paragraph (d)(1) to pre-1985 contribution.* See paragraph (d)(1) of this section with regard to contributions of money made on or before December 31, 1984.

(b) *Charitable contributions of property other than money made in taxable years beginning after December 31, 1982*—(1) *In general.* Except in the case of certain charitable contributions of property made after December 31, 1984, to which paragraph (c) of this section applies, any taxpayer who makes a charitable contribution of property other than money in a taxable year beginning after December 31, 1982, shall maintain for each contribution a receipt from the donee showing the following information:

(i) The name of the donee.

(ii) The date and location of the contribution.

(iii) A description of the property in detail reasonably sufficient under the circumstances. Although the fair market value of the property is one of the circumstances to be taken into account in determining the amount of detail to be included on the receipt, such value need not be stated on the receipt.

A letter or other written communication from the donee acknowledging receipt of the contribution, showing the date of the contribution, and containing the required description of the property contributed constitutes a receipt for purposes of this paragraph. A receipt is not required if the contribution is made in circumstances where it is impractical to obtain a receipt (*e.g.*, by depositing property at a charity's unattended drop site). In such cases, however, the taxpayer shall maintain reliable written records with respect to each item of donated property that include the information required by paragraph (b)(2)(ii) of this section.

(2) *Special rules*—(i) *Reliability of records.* The rules described in paragraph (a)(2)(i) of this section also apply to this paragraph (b) for determining the reliability of the written records described in paragraph (b)(1) of this section

(ii) *Content of records.* The written records described in paragraph (b)(1) of this section shall include the following information and such information shall be stated in the taxpayers income tax return if required by the return form or its instructions:

(A) The name and address of the donee organization to which the contribution was made.

(B) The date and location of the contribution.

(C) A description of the property in detail reasonable under the circumstances (including the value of the property), and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

(D) The fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser.

(E) In the case of property to which section 170(e) applies, the cost or other basis, adjusted as provided by section 1016, the reduction by reason of section 170(e)(1) in the amount of the charitable contribution otherwise taken into account, and the manner in which such reduction was determined. A taxpayer who elects under paragraph (d)(2) of § 1.170A–8 to apply section 170(e)(1) to contributions and carryovers of 30 percent capital gain property shall maintain a written record indicating the years for which the election was made and showing the contributions in the current year and carryovers from preceding years to which it applies. For the definition of the term ''30-percent capital gain property,'' see paragraph (d)(3) of § 1.170A–8.

(F) If less than the entire interest in the property is contributed during the taxable year, the total amount claimed as a deduction for the taxable year due to the contribution of the property, and the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to which the property giving rise to the deduction was contributed, having actual possession of the property.

(G) The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or other disposition of the property contributed, including for example, the terms of any agreement or understanding which:

(*1*) Restricts temporarily or permanently the donee's right to use or dispose of the donated property,

(*2*) Reserves to, or confers upon, anyone (other than the donee organization or an organization participating with the donee organization in cooperative fundraising) any right to the income from the donated property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(*3*) Earmarks donated property for a particular use.

(3) *Deductions in excess of $500 claimed for a charitable contribution of property other than money*—(i) *In general.* In addition to the information required under paragraph (b)(2)(ii) of this section, if a taxpayer makes a charitable contribution of property other than money in a taxable year beginning after December 31, 1982, and claims a deduction in excess of $500 in respect of the contribution of such item, the taxpayer shall maintain written records that include the following information with respect to such item of donated property, and shall state such information in his or her income tax return if required by the return form or its instructions:

(A) The manner of acquisition, as for example by purchase, gift bequest, inheritance, or exchange, and the approximate date of acquisition of the property by the taxpayer or, if the property was created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed.

(B) The cost or other basis, adjusted as provided by section 1016, of property, other than publicly traded securities, held by the taxpayer for a period of less than 12 months (6 months for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988, immediately preceding the date on which the contribution was made and, when the information is available, of property, other than publicly traded securities, held for a period of 12 months or more (6 months or more for property contributed in taxable years beginning after December 31, 1982, and on or before June 6, 1988, preceding the date on which the contribution was made.

(ii) *Information on acquisition date or cost basis not available.* If the return form or its instructions require the taxpayer to provide information on either the acquisition date of the property or the cost basis as described in paragraph (b)(3)(i) (A) and (B), respectively, of this section, and the taxpayer has reasonable cause for not being able to provide such information, the taxpayer shall attach an explanatory statement to the return. If a taxpayer has reasonable cause for not being able to provide such information, the taxpayer shall not be disallowed a charitable contribution deduction under section 170 for failure to comply with paragraph (b)(3)(i) (A) and (B) of the section.

(4) *Taxpayer option to apply paragraph (d) (1) and (2) to pre-1985 contributions.* See paragraph (d) (1) and (2) of this section with regard to contributions of property made on or before December 31, 1984.

(c) *Deductions in excess of $5,000 for certain charitable contributions of property made after December 31, 1984*—(1) *General Rule*—(i) *In general.* This paragraph applies to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money and publicly traded securities to which §1.170A–13(c)(7)(xi)(B) does not apply if the amount claimed or reported as a deduction under section 170 with respect to such item exceeds $5,000. This paragraph also applies to charitable contributions by C corporations (as defined in section 1361(a)(2) of the Code) to the extent described in paragraph (c)(2)(ii) of this section. No deduction under section 170 shall be allowed with respect to a charitable contribution to which this paragraph applies unless the substantiation requirements described in paragraph (c)(2) of this section are met. For purposes of this paragraph (c), the amount claimed or reported as a deduction for an item of property is the aggregate amount claimed or reported as a deduction for a charitable contribution under section 170 for such items of property and all similar items of property (as defined in paragraph (c)(7)(iii) of this section) by the same donor for the same taxable year (whether or not donated to the same donee).

(ii) *Special rule for property to which section 170(e) (3) or (4) applies.* For purposes of this paragraph (c), in computing the amount claimed or reported as a deduction for donated property to which section 170(e) (3) or (4) applies (pertaining to certain contributions of inventory and scientific equipment) there shall be taken into account only the amount claimed or reported as a deduction in excess of the amount which would have been taken into account for tax purposes by the donor as costs of goods sold if the donor had sold the contributed property to the donee. For example, assume that a donor makes a contribution from inventory of clothing for the care of the needy to which section 170(e)(3) applies. The cost of the property to the donor was $5,000, and, pursuant to section 170(e)(3)(B), the donor claims a charitable contribution deduction of $8,000 with respect to the property. Therefore, $3,000 ($8,000–$5,000) is the amount taken into account for purposes of determining whether the $5,000 threshold of this paragraph (c)(1) is met.

(2) *Substantiation requirements*—(i) *In general.* Except as provided in paragraph (c)(2)(ii) of this section, a donor who claims or reports a deduction with respect to a charitable contribution to which this paragraph (c) applies must comply with the following three requirements:

(A) Obtain a qualified appraisal (as defined in paragraph (c) (3) of this section) for such property contributed. If the contributed property is a partial interest, the appraisal shall be of the partial interest.

(B) Attach a fully completed appraisal summary (as defined in paragraph (c) (4) of this section) to the tax return (or, in the case of a donor that is a partnership or S corporation, the information return) on which the deduction for the contribution is first claimed (or reported) by the donor.

(C) Maintain records containing the information required by paragraph (b) (2) (ii) of this section.

(ii) *Special rules for certain nonpublicly traded stock, certain publicly traded securities, and contributions by certain C corporations.* (A) In cases described in paragraph (c)(2)(ii)(B) of this section, a qualified appraisal is not required, and only a partially completed appraisal summary form (as described in paragraph (c)(4)(iv)(A) of this section) is required to be attached to the tax or information return specified in paragraph (c)(2)(i)(B) of this section. However, in all cases donors must maintain records containing the information required by paragraph (b)(2)(ii) of this section.

(B) This paragraph (c)(2)(ii) applies in each of the following cases:

(*1*) The contribution of nonpublicly traded stock, if the amount claimed or reported as a deduction for the charitable contribution of such stock is greater than $5,000 but does not exceed $10,000;

(*2*) The contribution of a security to which paragraph (c)(7)(xi)(B) of this section applies; and

(*3*) The contribution of an item of property or of similar items of property described in paragraph (c)(1) of this section made after June 6, 1988, by a C corporation (as defined in section 1361(a)(2) of the Code), other than a closely held corporation or a personal service corporation.

(3) *Qualified appraisal*—(i) *In general.* For purposes of this paragraph (c), the term ''qualified appraisal'' means an appraisal document that—

(A) Relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property nor later than the date specified in paragraph (c)(3)(iv)(B) of this section;

(B) Is prepared, signed, and dated by a qualified appraiser (within the meaning of paragraph (c)(5) of this section);

(C) Includes the information required by paragraph (c)(3)(ii) of this section; and

(D) Does not involve an appraisal fee prohibited by paragraph (c)(6) of this section.

(ii) *Information included in qualified appraisal.* A qualified appraisal shall include the following information:

(A) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was (or will be) contributed;

(B) In the case of tangible property, the physical condition of the property;

(C) The date (or expected date) of contribution to the donee;

(D) The terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed, including, for example, the terms of any agreement or understanding that—

(*1*) Restricts temporarily or permanently a donee's right to use or dispose of the donated property,

(*2*) Reserves to, or confers upon, anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right to the income from the contributed property or to the possession of the property, including the right to vote donated securities, to acquire the property by purchase or otherwise, or to designate the person having such income, possession, or right to acquire, or

(*3*) Earmarks donated property for a particular use;

(E) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser; and, if the qualified appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person (whether an individual, corporation, or partnerships), or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number (if a number is otherwise required by section 6109 and the regulations thereunder) of the partnership or the person who employs or engages the qualified appraiser;

(F) The qualifications of the qualified appraiser who signs the appraisal, including the appraiser's background, experience, education, and membership, if any, in professional appraisal associations;

(G) A statement that the appraisal was prepared for income tax purposes;

(H) The date (or dates) on which the property was appraised;

(I) The appraised fair market value (within the meaning of §1.170A–1 (c)(2)) of the property on the date (or expected date) of contribution;

(J) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, and the replacement-cost-less-depreciation approach; and

(K) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

(iii) *Effect of signature of the qualified appraiser.* Any appraiser who falsely or fraudulently overstates the value of the contributed property referred to in a qualified appraisal or appraisal summary (as defined in paragraphs (c) (3) and (4), respectively, of this section) that the appraiser has signed may be subject to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability and, moreover, may have appraisals disregarded pursuant to 31 U.S.C. 330(c).

(iv) *Special rules*—(A) *Number of qualified appraisals.* For purposes of paragraph (c)(2)(i)(A) of this section, a separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. Only one qualified appraisal is required for a group of similar items of property contributed in the same taxable year of the donor, although a donor may obtain separate qualified appraisals for each item of property. A qualified appraisal prepared with respect to a group of similar items of property shall provide all the information required by paragraph (c)(3)(ii) of this section for each item of similar property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description of such items.

(B) *Time of receipt of qualified appraisal.* The qualified appraisal must be received by the donor before the due date (including extensions) of the return on which a deduction is first claimed (or reported in the case of a donor that is a partnership or S corporation) under section 170 with respect to the donated property, or, in the case of a deduction first claimed (or reported) on an amended return, the date on which the return is filed.

(C) *Retention of qualified appraisal.* The donor must retain the qualified appraisal in the donor's records for so long as it may be relevant in the administration of any internal revenue law.

(D) *Appraisal disregarded pursuant to 31 U.S.C. 330(c).* If an appraisal is disregarded pursuant to 31 U.S.C. 330(c) it shall have no probative effect as to the value of the appraised property. Such appraisal will, however, otherwise constitute a ''qualified appraisal'' for purposes of this paragraph (c) if the appraisal summary includes the declaration described in paragraph (c)(4)(ii)(L)(*2*) and the taxpayer had no knowledge that such declaration was false as of the time described in paragraph (c)(4)(i)(B) of this section.

(4) *Appraisal summary*—(i) *In general.* For purposes of this paragraph (c), except as provided in paragraph (c)(4)(iv)(A) of this section, the term *appraisal summary* means a summary of a qualified appraisal that—

(A) Is made on the form prescribed by the Internal Revenue Service;

(B) Is signed and dated (as described in paragraph (c)(4)(iii) of this section) by the donee (or presented to the donee for signature in cases described in paragraph (c)(4)(iv)(C)(*2*) of this section);

(C) Is signed and dated by the qualified appraiser (within the meaning of paragraph (c)(5) of this section) who prepared the qualified appraisal (within the meaning of paragraph (c)(3) of this section); and

(D) Includes the information required by paragraph (c)(4)(ii) of this section.

(ii) *Information included in an appraisal summary.* An appraisal summary shall include the following information:

(A) The name and taxpayer identification number of the donor (social security number if the donor is an individual or employer identification number if the donor is a partnership or corporation);

(B) A description of the property in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was contributed;

(C) In the case of tangible property, a brief summary of the overall physical condition of the property at the time of the contribution;

(D) The manner of acquisition (*e.g.*, purchase, exchange, gift, or bequest) and the date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, a statment to that effect and the approximate date the property was substantially completed;

(E) The cost or other basis of the property adjusted as provided by section 1016;

(F) The name, address, and taxpayer identification number of the donee;

(G) The date the donee received the property;

(H) For charitable contributions made after June 6, 1988, a statement explaining whether or not the charitable contribution was made by means of a bargain sale and the amount of any consideration received from the donee for the contribution;

(I) The name, address, and (if a taxpayer identification number is otherwise required by section 6109 and the regulations thereunder) the identifying number of the qualified appraiser who signs the appraisal summary and of other persons as required by paragraph (c)(3)(ii)(E) of this section;

(J) The appraised fair market value of the property on the date of contribution;

(K) The declaration by the appraiser described in paragraph (c)(5)(i) of this section;

(L) A declaration by the appraiser stating that—

(*1*) The fee charged for the appraisal is not of a type prohibited by paragraph (c)(6) of this section; and

(*2*) Appraisals prepared by the appraiser are not being disregarded pursuant to 31 U.S.C. 330(c) on the date the appraisal summary is signed by the appraiser; and

(M) Such other information as may be specified by the form.

(iii) *Signature of the original donee.* The person who signs the appraisal summary for the donee shall be an official authorized to sign the tax or information returns of the donee, or a person specifically authorized to sign appraisal summaries by an official authorized to sign the tax or information returns of such done. In the case of a donee that is a governmental unit, the person who signs the appraisal summary for such donee shall be the official authorized by such donee to sign appraisal summaries. The signature of the donee on the appraisal summary does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in the appraisal summary on the date specified in the appraisal summary and that the donee understands the information reporting requirements imposed by section 6050L and §1.6050L–1. In general, §1.6050L–1 requires the donee to file an information return with the Internal Revenue Service in the event the donee sells, exchanges, consumes, or otherwise disposes of the property (or any portion thereof) described in the appraisal summary within 2 years after the date of the donor's contribution of such property.

(iv) *Special rules*—(A) *Content of appraisal summary required in certain cases.* With respect to contributions of nonpublicly traded stock described in paragraph (c)(2)(ii)(B)(*1*) of this section, contributions of securities described in paragraph (c)(7)(xi)(B) of this section, and contributions by C corporations described in paragraph (c)(2)(ii)(B)(*3*) of this section, the term *appraisal summary* means a document that—

(*1*) Complies with the requirements of paragraph (c)(4)(i) (A) and (B) of this section,

(*2*) Includes the information required by paragraph (c)(4)(ii) (A) through (H) of this section,

(*3*) Includes the amount claimed or reported as a charitable contribution deduction, and

(*4*) In the case of securities described in paragraph (c)(7)(xi)(B) of this section, also includes the pertinent average trading price (as described in paragraph (c)(7)(xi)(B)(*2*)(iii) of this section).

(B) *Number of appraisal summaries.* A separate appraisal summary for each item of property described in paragraph (c)(1) of this section must be attached to the donor's return. If, during the donor's taxable year, the donor contributes similar items of property described in paragraph (c)(1) of this section to more than one donee, the donor shall attach to the donor's return a separate appraisal summary for each donee. See paragraph (c)(7)(iii) of this section for the definition of similar items of property. If, however, during the donor's taxable year, a donor contributes similar items of property described in paragraph (c)(1) of this section to the same donee, the donor may attach to the donor's return a single appraisal summary with respect to all similar items of property contributed to the same donee. Such an appraisal summary shall provide all the information required by paragraph (c)(4)(ii) of this section for each item of property, except that the appraiser may select any items whose aggregate value is appraised at $100 or less and provide a group description for such items.

(C) *Manner of acquisition, cost basis and donee's signature.* (1) If a taxpayer has reasonable cause for being unable to provide the information required by paragraph (c)(4)(ii) (D) and (E) of this section (relating to the manner of acquisition and basis of the contributed property), an appropriate explanation should be attached to the appraisal summary. The taxpayer's deduction will not be disallowed simply because of the inability (for reasonable cause) to provide these items of information.

(*2*) In rare and unusual circumstances in which it is impossible for the taxpayer to obtain the signature of the donee on the appraisal summary as required by paragraph (c)(4)(i)(B) of this section, the taxpayer's deduction will not be disallowed for that reason provided that the taxpayer attaches a statement to the appraisal summary explaining, in detail, why it was not possible to obtain the donee's signature. For example, if the donee ceases to exist as an entity subsequent to the date of the contribution and prior to the date when the appraisal summary must be signed, and the donor acted reasonably in not obtaining the donee's signature at the time of the contribution, relief under this paragraph (c)(4)(iv)(C)(*2*) would generally be appropriate.

(D) *Information excluded from certain appraisal summaries.* The information required by paragraph (c)(4)(i)(C), paragraph (c)(4)(ii) (D), (E), (H) through (M), and paragraph (c)(4)(iv)(A)(*3*), and the average trading price referred to in paragraph (c)(4)(iv)(A)(*4*) of this section do not have to be included on the appraisal summary at the time it is signed by the donee or a copy is provided to the donee pursuant to paragraph (c)(4)(iv)(E) of this section.

(E) *Statement to be furnished by donors to donees.* Every donor who presents an appraisal summary to a donee for signature after June 6, 1988, in order to comply with paragraph (c)(4)(i)(B) of this section shall furnish a copy of the appraisal summary to such donee.

(F) *Appraisal summary required to be provided to partners and S corporation shareholders.* If the donor is a partnership or S corporation, the donor shall provide a copy of the appraisal summary to every partner or shareholder, respectively, who receives an allocation of a charitable contribution deduction under section 170 with respect to the property described in the appraisal summary.

(G) *Partners and S corporation shareholders.* A partner of a partnership or shareholder of an S corporation who receives an allocation of a deduction under section 170 for a charitable contribution of property to which this paragraph (c) applies must attach a copy of the partnership's or S corporation's appraisal summary to the tax return on which the deduction for the contribution is first claimed. If such appraisal summary is not attached, the partner's or shareholder's deduction shall not be allowed except as provided for in paragraph (c)(4)(iv)(H) of this section.

(H) *Failure to attach appraisal summary.* In the event that a donor fails to attach to the donor's return an appraisal summary as required by paragraph (c)(2)(i)(B) of this section, the Internal Revenue Service may request that the donor submit the appraisal summary within 90 days of the request. If such a request is made and the donor complies with the request within the 90-day period, the deduction under section 170 shall not be disallowed for failure to attach the appraisal summary, provided that the donor's failure to attach the appraisal summary was a good faith omission and the requirements of paragraph (c) (3) and (4) of this section are met (including the completion of the qualified appraisal prior to the date specified in paragraph (c)(3)(iv)(B) of this section).

(5) *Qualified appraiser*—(i) *In general.* The term *qualified appraiser* means an individual (other than a person described in paragraph (c)(5)(iv) of this section) who includes on the appraisal summary (described in paragraph (c)(4) of this section), a declaration that—

(A) The individual either holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis;

(B) Because of the appraiser's qualifications as described in the appraisal (pursuant to paragraph (c)(3)(ii)(F) of this section), the appraiser is qualified to make appraisals of the type of property being valued;

(C) The appraiser is not one of the persons described in paragraph (c)(5)(iv) of this section; and

(D) The appraiser understands that an intentionally false or fraudulent overstatement of the value of the property described in the qualified appraisal or appraisal summary may subject the appraiser to a civil penalty under section 6701 for aiding and abetting an understatement of tax liability, and, moreover, the appraiser may have appraisals disregarded pursuant to 31 U.S.C. 330(c) (see paragraph (c)(3)(iii) of this section).

(ii) *Exception.* An individual is not a qualified appraiser with respect to a particular donation, even if the declaration specified in paragraph (c)(5)(i) of this section is provided in the appraisal summary, if the donor had knowledge of facts that would cause a reasonable person to expect the appraiser falsely to overstate the value of the donated property (*e.g.,* the donor and the appraiser make an agreement concerning the amount at which the property will be valued and the donor knows that such amount exceeds the fair market value of the property).

(iii) *Numbers of appraisers.* More than one appraiser may appraise the donated property. If more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the charitable contribution deduction pursuant to this paragraph (c). If the donor uses the appraisal of more than one appraiser, or if two or more appraisers contribute to a single appraisal, each appraiser shall comply with the requirements of this paragraph (c), including signing the qualified appraisal and appraisal summary as required by paragraphs (c)(3)(i)(B) and (c)(4)(i)(C) of this section, respectively.

(iv) *Qualified appraiser exclusions.* The following persons cannot be qualified appraisers with respect to particular property:

(A) The donor or the taxpayer who claims or reports a deductions under section 170 for the contribution of the property that is being appraised.

(B) A party to the transaction in which the donor acquired the property being appraised (*i.e.*, the person who sold, exchanged, or gave the property to the donor, or any person who acted as an agent for the transferor or for the donor with respect to such sale, exchange, or gift), unless the property is donated within 2 months of the date of acquisition and its appraised value does not exceed its acquisition price.

(C) The donee of the property.

(D) Any person employed by any of the foregoing persons (*e.g.*, if the donor acquired a painting from an art dealer, neither the art dealer nor persons employed by the dealer can be qualified appraisers with respect to that painting).

(E) Any person related to any of the foregoing persons under section 267(b), or, with respect to appraisals made after June 6, 1988, married to a person who is in a relationship described in section 267(b) with any of the foregoing persons.

(F) An appraiser who is regularly used by any person described in paragraph (c)(5)(iv) (A), (B), or (C) of this section and who does not perform a majority of his or her appraisals made during his or her taxable year for other persons.

(6) *Appraisal fees*—(i) *In general.* Except as otherwise provided in paragraph (c)(6)(ii) of this section, no part of the fee arrangement for a qualified appraisal can be based, in effect, on a percentage (or set of percentages) of the appraised value of the property. If a fee arrangement for an appraisal is based in whole or in part on the amount of the appraised value of the property, if any, that is allowed as a deduction under section 170, after Internal Revenue Service examination or otherwise, it shall be treated as a fee based on a percentage of the appraised value of the property. For example, an appraiser's fee that is subject to reduction by the same percentage as the appraised value may be reduced by the Internal Revenue Service would be treated as a fee that violates this paragraph (c)(6).

(ii) *Exception.* Paragraph (c)(6)(i) of this section does not apply to a fee paid to a generally recognized association that regulates appraisers provided all of the following requirements are met:

(A) The association is not organized for profit and no part of the net earnings of the association inures to the benefit of any private shareholder or individual (these terms have the same meaning as in section 501(c)),

(B) The appraiser does not receive any compensation from the association or any other persons for making the appraisal, and

(C) The fee arrangement is not based in whole or in part on the amount of the appraised value of the donated property, if any, that is allowed as a deduction under section 170 after Internal Revenue Service examination or otherwise.

(7) *Meaning of terms.* For purposes of this paragraph (c)—

(i) *Closely held corporation.* The term *closely held corporation* means any corporation (other than an S corporation) with respect to which the stock ownership requirement of paragraph (2) of section 542(a) of the Code is met.

(ii) *Personal service corporation.* The term *personal service corporation* means any corporation (other than an S corporation) which is a service organization (within the meaning of section 414(m)(3) of the Code).

(iii) *Similar items of property*. The phrase *similar items of property* means property of the same generic category or type, such as stamp collections (including philatelic supplies and books on stamp collecting), coin collections (including numismatic supplies and books on coin collecting), lithographs, paintings, photographs, books, nonpublicly traded stock, nonpublicly traded securities other than nonpublicly trade stock, land, buildings, clothing, jewelry, funiture, electronic equipment, household appliances, toys, everyday kitchenware, china, crystal, or silver. For example, if a donor claims on her return for the year deductions of $2,000 for books given by her to College A, $2,500 for books given by her to College B, and $900 for books given by her to College C, the $5,000 threshold of paragraph (c)(1) of this section is exceeded. Therefore, the donor must obtain a qualified appraisal for the books and attach to her return three appraisal summaries for the books donated to A, B, and C. For rules regarding the number of qualified appraisals and appraisal summaries required when similar items of property are contributed, see paragraphs (c)(3)(iv)(A) and (c)(4)(iv)(B), respectively, of this section.

(iv) *Donor*. The term *donor* means a person or entity (other than an organization described in section 170(c) to which the donated property was previously contributed) that makes a charitable contribution of property.

(v) *Donee*. The term *donee* means—

(A) Except as provided in paragraph (c)(7)(v) (B) and (C) of this section, an organization described in section 170(c) to which property is contributed,

(B) Except as provided in paragraph (c)(7)(v)(C) of this section, in the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c), the trust, or

(C) In the case of a charitable contribution of property placed in trust for the benefit of an organization described in section 170(c) made on or before June 6, 1988, the beneficiary that is an organization described in section 170(c), or if the trust has assumed the duties of a donee by signing the appraisal summary pursuant to paragraph (c)(4)(i)(B) of this section, the trust.

In general, the term, refers only to the original donee. However, with respect to paragraph (c)(3)(ii)(D), the last sentence of paragraph (c)(4)(iii), and paragraph (c)(5)(iv)(C) of this section, the term *donee* means the original donee and all successor donees in cases where the original donee transfers the contributed property to a successor donee after July 5, 1988.

(vi) *Original donee*. The term *original donee* means the donee to or for which property is initially donated by a donor.

(vii) *Successor donee*. The term *successor donee* means any donee of property other than its original donee (*i.e.*, a transferee of property for less than fair market value from an original donee or another successor donee).

(viii) *Fair market value*. For the meaning of the term *fair market value*, see section 1.170A–1(c)(2).

(ix) *Nonpublicly traded securities*. The term *nonpublicly traded securities* means securities (within the meaning of section 165(g)(2) of the Code) which are not publicly traded securities as defined in paragraph (c)(7)(xi) of this section.

(x) *Nonpublicly traded stock*. The term *nonpublicly traded stock* means any stock of a corporation (evidence by a stock certificate) which is not a publicly traded security. The term stock does not include a debenture or any other evidence of indebtedness.

(xi) *Publicly traded securities*—(A) *In general*. Except as provided in paragraph (c)(7)(xi)(C) of this section, the term *publicly traded securities* means securities (within the meaning of section 165(g)(2) of the Code) for which (as of the date of the contribution) market quotations are readily available on an established securities market. For purposes of this section, market quotations are readily available on an established securities market with respect to a security if:

(*1*) The security is listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations are published on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange in which quotations are published on a daily basis;

(*2*) The security is regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*3*) The security is a share of an open-end investment company (commonly known as a mutual fund) registered under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1 to 80b–2), for which quotations are published on a daily basis in a newspaper of general circulation throughout the United States.

(If the market value of an issue of a security is reflected only on an interdealer quotation system, the issue shall not be considered to be publicly traded unless the special rule described in paragraph (c)(7)(xi)(B) of this section is satisfied.)

(B) *Special rule*—(*1*) *In General*. An issue of a security that does not satisfy the requirements of paragraph (c)(7)(xi)(A) (*1*), (*2*), or (*3*) of this section shall nonetheless be considered to have market quotations readily available on an established securities market for purposes of paragraph (c)(7)(xi)(A) of this section if all of the following five requirements are met:

(*i*) The issue is regularly traded during the computational period (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iv*) of this section) in a market that is reflected by the existence of an interdealer quotation system for the issue,

(*ii*) The issuer or an agent of the issuer computes the average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section) for the issue for the computational period,

(*iii*) The average trading price and total volume of the issue during the computational period are published in a newspaper of general circulation throughout the United States not later than the last day of the month following the end of the calendar quarter in which the computational period ends,

(*iv*) The issuer or its agent keeps books and records that list for each transaction during the computational period involving each issue covered by this procedure the date of the settlement of the transaction, the name and address of the broker or dealer making the market in which the transaction occurred, and the trading price and volume, and

(*v*) The issuer or its agent permits the Internal Revenue Service to review the books and records described in paragraph (c)(7)(xi)(B)(*1*)(*iv*) of this section with respect to transactions during the computational period upon giving reasonable notice to the issuer or agent.

(*2*) *Definitions*. For purposes of this paragraph (c)(7)(xi)(B)—

(*i*) *Issue of a security*. The term *issue of a security* means a class of debt securities with the same obligor and identical terms except as to their relative denominations (amounts) or a class of stock having identical rights.

(*ii*) *Interdealer quotation system*. The term *interdealer quotation system* means any system of general circulation to brokers and dealers that regularly disseminates quotations of obligations by two or more identified brokers or dealers, who are not related to either the issuer of the security or to the issuer's agent, who compute the average trading price of the security. A quotation sheet prepared and distributed by a broker or dealer in the regular course of its business and containing only quotations of such broker or dealer is not an interdealer quotation system.

(*iii*) *Average trading price*. The term *average trading price* means the mean price of all transactions (weighted by volume), other than original issue or redemption transactions, conducted through a United States office of a broker or dealer who maintains a market in the issue of the security during the computational period. For this purpose, bid and asked quotations are not taken into account.

(*iv*) *Computational period*. For calendar quarters beginning on or after June 6, 1988, the term *computational period* means weekly during October through December (beginning with the first Monday in October and ending with the first Sunday following the last Monday in December) and monthly during January through September (beginning January 1). For calendar quarters beginning before June 6, 1988, the term *computational period* means weekly during October through December and monthly during January through September.

(C) *Exception.* Securities described in paragraph (c)(7)(xi) (A) or (B) of this section shall not be considered publicly traded securities if—

(*1*) The securities are subject to any restrictions that materially affect the value of the securities to the donor or prevent the securities from being freely traded, or

(*2*) If the amount claimed or reported as a deduction with respect to the contribution of the securities is different than the amount listed in the market quotations that are readily available on an established securities market pursuant to paragraph (c)(7)(xi) (A) or (B) of this section.

(D) *Market quotations and fair market value.* The fair market value of a publicly traded security, as defined in this paragraph (c)(7)(xi), is not necessarily equal to its market quotation, its average trading price (as defined in paragraph (c)(7)(xi)(B)(*2*)(*iii*) of this section), or its face value, if any. See section 1.170A–1(c)(2) for the definition of *fair market value.*

(d) *Charitable contributions; information required in support of deductions for taxable years beginning before January 1, 1983*—(1) *In general.* This paragraph (d)(1) shall apply to deductions for charitable contributions made in taxable years beginning before January 1, 1983. At the option of the taxpayer the requirements of this paragraph (d)(1) shall also apply to all charitable contributions made on or before December 31, 1984 (in lieu of the requirements of paragraphs (a) and (b) of this section). In connection with claims for deductions for charitable contributions, taxpayers shall state in their income tax returns the name of each organization to which a contribution was made and the amount and date of the actual payment of each contribution. If a contribution is made in property other than money, the taxpayer shall state the kind of property contributed, for example, used clothing, paintings, or securities, the method utilized in determining the fair market value of the property at the time the contribution was made, and whether or not the amount of the contribution was reduced under section 170(e). If a taxpayer makes more than one cash contribution to an organization during the taxable year, then in lieu of listing each cash contribution and the date of payment the taxpayer may state the total cash payments made to such organization during the taxable year. A taxpayer who elects under paragraph (d)(2) of §1.170A–8 to apply section 170(e)(1) to his contributions and carryovers of 30-percent capital gain property must file a statement with his return indicating that he has made the election and showing the contributions in the current year and carryovers from preceding years to which it applies. For the definition of the term *30-percent capital gain property*, see paragraph (d)(3) of §1.170A–8.

(2) *Contribution by individual of property other than money.* This paragraph (d)(2) shall apply to deductions for charitable contributions made in taxable years beginning before January 1, 1983. At the option of the taxpayer, the requirements of this paragraph (d)(2) shall also apply to contributions of property made on or before December 31, 1984 (in lieu of the requirements of paragraph (b) of this section). If an individual taxpayer makes a charitable contribution of an item of property other than money and claims a deduction in excess of $200 in respect of his contribution of such item, he shall attach to his income tax return the following information with respect to such item:

(i) The name and address of the organization to which the contribution was made.

(ii) The date of the actual contribution.

(iii) A description of the property in sufficient detail to identify the particular property contributed, including in the case of tangible property the physical condition of the property at the time of contribution, and, in the case of securities, the name of the issuer, the type of security, and whether or not such security is regularly traded on a stock exchange or in an over-the-counter market.

(iv) The manner of acquisition, as, for example, by purchase, gift, bequest, inheritance, or exchange, and the approximate date of acquisition of the property by the taxpayer or, if the property was created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed.

(v) The fair market value of the property at the time the contribution was made, the method utilized in determining the fair market value, and, if the valuation was determined by appraisal, a copy of the signed report of the appraiser.

(vi) The cost or other basis, adjusted as provided by section 1016, of property, other than securities, held by the taxpayer for a period of less than 5 years immediately preceding the date on which the contribution was made and, when the information is available, of property, other than securities, held for a period of 5 years or more preceding the date on which the contribution was made.

(vii) In the case of property to which section 170(e) applies, the cost or other basis, adjusted as provided by section 1016, the reduction by reason of section 170(e)(1) in the amount of the charitable contribution otherwise taken into account, and the manner in which such reduction was determined.

(viii) The terms of any agreement or understanding entered into by or on behalf of the taxpayer which relates to the use, sale, or disposition of the property contributed, as, for example, the terms of any agreement or understanding which:

(A) Restricts temporarily or permanently the donee's right to dispose of the donated property,

(B) Reserves to, or confers upon, anyone other than the donee organization or other than an organization participating with such organization in cooperative fundraising, any right to the income from such property, to the possession of the property, including the right to vote securities, to acquire such property by purchase or otherwise, or to designate the person to have such income, possession, or right to acquire, or

(C) Earmarks contributed property for a particular charitable use, such as the use of donated furniture in the reading room of the donee organization's library.

(ix) The total amount claimed as a deduction for the taxable year due to the contribution of the property and, if less than the entire interest in the property is contributed during the taxable year, the amount claimed as a deduction in any prior year or years for contributions of other interests in such property, the name and address of each organization to which any such contribution was made, the place where any such property which is tangible property is located or kept, and the name of any person, other than the organization to which the property giving rise to the deduction was contributed, having actual possession of the property.

(3) *Statement from donee organization.* Any deduction for a charitable contribution must be substantiated, when required by the district director, by a statement from the organization to which the contribution was made indicating whether the organization is a domestic organization, the name and address of the contributor, the amount of the contribution, the date of actual receipt of the contribution, and such other information as the district director may deem necessary. If the contribution includes an item of property, other than money or securities which are regularly traded on a stock exchange or in an over-the-counter market, which the donee deems to have a fair market value in excess of $500 ($200 in the case of a charitable contribution made in a taxable year beginning before January 1, 1983) at the time of receipt, such statement shall also indicate for each such item its location if it is retained by the organization, the amount received by the organization on any sale of the property and the date of sale or, in case of any other disposition of the property, the method of disposition. In the case of any contribution of tangible personal property, the statement shall indicate the use of the property by the organization and whether or not it is used for a purpose or function constituting the basis for the donee organization's exemption from income tax under section 501 or, in the case of a governmental unit,

whether or not it is used for exclusively public purposes.

(e) [Reserved]

(f) *Substantiation of charitable contributions of $250 or more*—(1) *In general.* No deduction is allowed under section 170(a) for all or part of any contribution of $250 or more unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment from the donee organization. A taxpayer who makes more than one contribution of $250 or more to a donee organization in a taxable year may substantiate the contributions with one or more contemporaneous written acknowledgments. Section 170(f)(8) does not apply to a payment of $250 or more if the amount contributed (as determined under §1.170A–1(h)) is less than $250. Separate contributions of less than $250 are not subject to the requirements of section 170(f)(8), regardless of whether the sum of the contributions made by a taxpayer to a donee organization during a taxable year equals $250 or more.

(2) *Written acknowledgment.* Except as otherwise provided in paragraphs (f)(8) through (f)(11) and (f)(13) of this section, a written acknowledgment from a donee organization must provide the following information—

(i) The amount of any cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization;

(ii) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization;

(iii) If the donee organization provides any goods or services other than intangible religious benefits (as described in section 170(f)(8)), a description and good faith estimate of the value of those goods or services; and

(iv) If the donee organization provides any intangible religious benefits, a statement to that effect.

(3) *Contemporaneous.* A written acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of—

(i) The date the taxpayer files the original return for the taxable year in which the contribution was made; or

(ii) The due date (including extensions) for filing the taxpayer's original return for that year.

(4) *Donee organization.* For purposes of this paragraph (f), a donee organization is an organization described in section 170(c).

(5) *Goods or services.* Goods or services means cash, property, services, benefits, and privileges.

(6) *In consideration for.* A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment. Goods or services a donee organization provides in consideration for a payment by a taxpayer include goods or services provided in a year other than the year in which the taxpayer makes the payment to the donee organization.

(7) *Good faith estimate.* For purposes of this section, good faith estimate means a donee organization's estimate of the fair market value of any goods or services, without regard to the manner in which the organization in fact made that estimate. See §1.170A–1(h)(6) for rules regarding when a taxpayer may treat a donee organization's estimate of the value of goods or services as the fair market value.

(8) *Certain goods or services disregarded*—(i) *In general.* For purposes of section 170(f)(8), the following goods or services are disregarded—

(A) Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90–12, 1990–1 C.B. 471, 92–49, 1992-1 C.B. 987, and any successor documents. (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.); and

(B) Annual membership benefits offered to a taxpayer in exchange for a payment of $75 or less per year that consist of—

(*1*) Any rights or privileges, other than those described in section 170(l), that the taxpayer can exercise frequently during the membership period. Examples of such rights and privileges may include, but are not limited to, free or discounted admission to the organization's facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services; and

(*2*) Admission to events during the membership period that are open only to members of a donee organization and for which the donee organization reasonably projects that the cost per person (excluding any allocable overhead) attending each such event is within the limits established for ''low cost articles'' under section 513(h)(2). The projected cost to the donee organization is determined at the time the organization first offers its membership package for the year (using section 3.07 of Revenue Procedure 90–12, or any successor documents, to determine the cost of any items or services that are donated).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (f)(8).

Example 1. Membership benefits disregarded. Performing Arts Center *E* is an organization described in section 170(c). In return for a payment of $75, *E* offers a package of basic membership benefits that includes the right to purchase tickets to performances one week before they go on sale to the general public, free parking in *E*'s garage during evening and weekend performances, and a 10% discount on merchandise sold in *E*'s gift shop. In return for a payment of $150, *E* offers a package of preferred membership benefits that includes all of the benefits in the $75 package as well as a poster that is sold in *E*'s gift shop for $20. The basic membership and the preferred membership are each valid for twelve months, and there are approximately 50 performances of various productions at *E* during a twelve-month period. *E*'s gift shop is open for several hours each week and at performance times. *F*, a patron of the arts, is solicited by *E* to make a contribution. *E* offers *F* the preferred membership benefits in return for a payment of $150 or more. *F* makes a payment of $300 to *E*. *F* can satisfy the substantiation requirement of section 170(f)(8) by obtaining a contemporaneous written acknowledgment from *E* that includes a description of the poster and a good faith estimate of its fair market value ($20) and disregards the remaining membership benefits.

Example 2. Contemporaneous written acknowledgment need not mention rights or privileges that can be disregarded. The facts are the same as in Example 1, except that *F* made a payment of $300 and received only a basic membership. *F* can satisfy the section 170(f)(8) substantiation requirement with a contemporaneous written acknowledgment stating that no goods or services were provided.

Example 3. Rights or privileges that cannot be exercised frequently. Community Theater Group *G* is an organization described in section 170(c). Every summer, *G* performs four different plays. Each play is performed two times. In return for a membership fee of $60, *G* offers its members free admission to any of its performances. Non-members may purchase tickets on a performance by performance basis for $15 a ticket. *H*, an individual who is a sponsor of the theater, is solicited by *G* to make a contribution. *G* tells *H* that the membership benefit will be provided in return for any payment of $60 or more. *H* chooses to make a payment of $350 to *G* and receives in return the membership benefit. *G*'s membership benefit of free admission is not described in paragraph (f)(8)(i)(B) of this section because it is not a privilege that can be exercised frequently (due to the limited number of performances offered by *G*). Therefore, to meet the requirements of section 170(f)(8), a contemporaneous written acknowledgment of *H*'s $350 payment must include a description of the free admission benefit and a good faith estimate of its value.

Example 4. Multiple memberships. In December of each year, *K*, an individual, gives each of her six grandchildren a junior membership in Dinosaur Museum, an organization described in section 170(c). Each junior membership costs $50, and *K* makes a single payment of $300 for all six memberships. A junior member is entitled to free admission to the museum and to weekly films, slide shows, and lectures about dinosaurs. In addition, each junior member receives a bimonthly, non-commercial quality newsletter with information about dinosaurs and upcoming events. *K*'s contemporaneous written acknowledgment from Dinosaur Museum may state that no goods or services were provided in exchange for *K*'s payment.

(9) *Goods or services provided to employees or partners of donors*—(i) *Certain goods or services disregarded.* For purposes of section 170(f)(8), goods or services provided by a donee organization to employees of a donor, or to partners of a partnership that is a donor, in return for a payment to the organization may be disregarded to the extent that the goods or services provided to each employee or partner are the same as those described in paragraph (f)(8)(i) of this section.

(ii) *No good faith estimate required for other goods or services.* If a taxpayer makes a contribution of $250 or more to a donee organization and, in return, the donee organization offers the taxpayer's employees or partners goods or services other than those described in paragraph (f)(9)(i) of this section, the contemporaneous written acknowledgment of the taxpayer's contribution is not required to include a good faith estimate of the value of such goods or services but must include a description of those goods or services.

(iii) *Example.* The following example illustrates the rules of this paragraph (f)(9).

Example. Museum *J* is an organization described in section 170(c). For a payment of $40, *J* offers a package of basic membership benefits that includes free admission and a 10% discount on merchandise sold in *J*'s gift shop. *J*'s other membership categories are for supporters who contribute $100 or more. Corporation *K* makes a payment of $50,000 to *J* and, in return, *J* offers *K*'s employees free admission for one year, a tee-shirt with *J*'s logo that costs *J* $4.50, and a gift shop discount of 25% for one year. The free admission for *K*'s employees is the same as the benefit made available to holders of the $40 membership and is otherwise described in paragraph (f)(8)(i)(B) of this section. The tee-shirt given to each of *K*'s employees is described in paragraph (f)(8)(i)(A) of this section. Therefore, the contemporaneous written acknowledgment of *K*'s payment is not required to include a description or good faith estimate of the value of the free admission or the tee-shirts. However, because the gift shop discount offered to *K*'s employees is different than that offered to those who purchase the $40 membership, the discount is not described in paragraph (f)(8)(i) of this section. Therefore, the contemporaneous written acknowledgment of *K*'s payment is required to include a description of the 25% discount offered to *K*'s employees.

(10) *Substantiation of out-of-pocket expenses.* A taxpayer who incurs unreimbursed expenditures incident to the rendition of services, within the meaning of § 1.170A–1(g), is treated as having obtained a contemporaneous written acknowledgment of those expenditures if the taxpayer—

(i) Has adequate records under paragraph (a) of this section to substantiate the amount of the expenditures; and

(ii) Obtains by the date prescribed in paragraph (f)(3) of this section a statement prepared by the donee organization containing—

(A) A description of the services provided by the taxpayer;

(B) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for the unreimbursed expenditures; and

(C) The information required by paragraphs (f)(2) (iii) and (iv) of this section.

(11) *Contributions made by payroll deduction*—(i) *Form of substantiation.* A contribution made by means of withholding from a taxpayer's wages and payment by the taxpayer's employer to a donee organization may be substantiated, for purposes of section 170(f)(8), by both—

(A) A pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld by the employer for the purpose of payment to a donee organization; and

(B) A pledge card or other document prepared by or at the direction of the donee organization that includes a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

(ii) *Application of $250 threshold.* For the purpose of applying the $250 threshold provided in section 170(f)(8)(A) to contributions made by the means described in paragraph (f)(11)(i) of this section, the amount withheld from each payment of wages to a taxpayer is treated as a separate contribution.

(12) *Distributing organizations as donees.* An organization described in section 170(c), or an organization described in 5 CFR 950.105 (a Principal Combined Fund Organization for purposes of the Combined Federal Campaign) and acting in that capacity, that receives a payment made as a contribution is treated as a donee organization solely for purposes of section 170(f)(8), even if the organization (pursuant to the donor's instructions or otherwise) distributes the amount received to one or more organizations described in section 170(c). This paragraph (f)(12) does not apply, however, to a case in which the distributee organization provides goods or services as part of a transaction structured with a

view to avoid taking the goods or services into account in determining the amount of the deduction to which the donor is entitled under section 170.

(13) *Transfers to certain trusts.* Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2) or (d)(3) or §1.664(3)(a)(1)(i)(*b*)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)); for such a transfer, the contemporaneous written acknowledgment must state that the contribution was transferred to the donee organization's pooled income fund and indicate whether any goods or services (in addition to an income interest in the fund) were provided in exchange for the transfer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the income interest.

(14) *Substantiation of payments to a college or university for the right to purchase tickets to athletic events.* For purposes of paragraph (f)(2)(iii) of this section, the right to purchase tickets for seating at an athletic event in exchange for a payment described in section 170(l) is treated as having a value equal to twenty percent of such payment. For example, when a taxpayer makes a payment of $312.50 for the right to purchase tickets for seating at an athletic event, the right to purchase tickets is treated as having a value of $62.50. The remaining $250 is treated as a charitable contribution, which the taxpayer must substantiate in accordance with the requirements of this section.

(15) *Substantiation of charitable contributions made by a partnership or an S corporation.* If a partnership or an S corporation makes a charitable contribution of $250 or more, the partnership or S corporation will be treated as the taxpayer for purposes of section 170(f)(8). Therefore, the partnership or S corporation must substantiate the contribution with a contemporaneous written acknowledgment from the donee organization before reporting the contribution on its income tax return for the year in which the contribution was made and must maintain the contemporaneous written acknowledgment in its records. A partner of a partnership or a shareholder of an S corporation is not required to obtain any additional substantiation for his or her share of the partnership's or S corporation's charitable contribution.

(16) *Purchase of an annuity.* If a taxpayer purchases an annuity from a charitable organization and claims a charitable contribution deduction of $250 or more for the excess of the amount paid over the value of the annuity, the contemporaneous written acknowledgment must state whether any goods or services in addition to the annuity were provided to the taxpayer. The contemporaneous written acknowledgment is not required to include a good faith estimate of the value of the annuity. See §1.170A–1(d)(2) for guidance in determining the value of the annuity.

(17) *Substantiation of matched payments*—(i) *In general.* For purposes of section 170, if a taxpayer's payment to a donee organization is matched, in whole or in part, by another payor, and the taxpayer receives goods or services in consideration for its payment and some or all of the matching payment, those goods or services will be treated as provided in consideration for the taxpayer's payment and not in consideration for the matching payment.

(ii) *Example.* The following example illustrates the rules of this paragraph (f)(17).

Example. Taxpayer makes a $400 payment to Charity *L*, a donee organization. Pursuant to a matching payment plan, Taxpayer's employer matches Taxpayer's $400 payment with an additional payment of $400. In consideration for the combined payments of $800, *L* gives Taxpayer an item that it estimates has a fair market value of $100. *L* does not give the employer any goods or services in consideration for its contribution. The contemporaneous written acknowledgment provided to the employer must include a statement that no goods or services were provided in consideration for the employer's $400 payment. The contemporaneous written acknowledgment provided to Taxpayer must include a statement of the amount of Taxpayer's payment, a description of the item received by Taxpayer, and a statement that *L*'s good faith estimate of the value of the item received by Taxpayer is $100.

(18) *Effective date.* This paragraph (f) applies to contributions made on or after December 16, 1996. However, taxpayers may rely on the rules of this paragraph (f) for contributions made on or after January 1, 1994.

[T.D. 8002, 49 FR 50664, 50666, Dec. 31, 1984, as amended by T.D. 8003, 49 FR 50659, Dec. 31, 1984; T.D. 8199, 53 FR 16080, May 5, 1988; 53 FR 18372, May 23, 1988; T.D. 8623, 60 FR 53128, Oct. 12, 1995; T.D. 8690, 61 FR 65952, Dec. 16, 1996; T.D. 9864, 84 FR 27530, June 13, 2019; T.D. 9907, 85 FR 48474, Aug. 11, 2020]

§ 1.170A–14 Qualified conservation contributions.

(a) *Qualified conservation contributions.* A deduction under section 170 of the Internal Revenue Code (Code) is generally not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property other than certain transfers in trust (*see* § 1.170A–6 relating to charitable contributions in trust and § 1.170A–7 relating to contributions not in trust of partial interests in property). However, a deduction may be allowed under section 170(f)(3)(B)(iii) for the value of a qualified conservation contribution if the requirements of this section are met and the contribution is not a disallowed qualified conservation contribution within the meaning of paragraph (j) of this section. A *qualified conservation contribution* is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. To be eligible for a deduction under section 170(h) and this section, the conservation purpose must be protected in perpetuity.

(b) *Qualified real property interest*—(1) *Entire interest of donor other than qualified mineral interest.* (i) The entire interest of the donor other than a qualified mineral interest is a qualified real property interest. A qualified mineral interest is the donor's interest in subsurface oil, gas, or other minerals and the right of access to such minerals.

(ii) A real property interest shall not be treated as an entire interest other than a qualified mineral interest by reason of section 170(h)(2)(A) and this paragraph (b)(1) if the property in which the donor's interest exists was divided prior to the contribution in order to enable the donor to retain control of more than a qualified mineral interest or to reduce the real property interest donated. See Treasury regulations § 1.170A–7(a)(2)(i). An entire interest in real property may consist of an undivided interest in the property. But see section 170(h)(5)(A) and the regulations thereunder (relating to the requirement that the conservation purpose which is the subject of the donation must be protected in perpetuity). Minor interests, such as rights-of-way, that will not interfere with the conservation purposes of the donation, may be transferred prior to the conservation contribution without affecting the treatment of a property interest as a qualified real property interest under this paragraph (b)(1).

(2) *Perpetual conservation restriction.* A ''perpetual conservation restriction'' is a qualified real property interest. A ''perpetual conservation restriction'' is a restriction granted in perpetuity on the use which may be made of real property—including, an easement or other interest in real property that under state law has attributes similar to an easement (e.g., a restrictive covenant or equitable servitude). For purposes of this section, the terms *easement, conservation restriction,* and *perpetual conservation restriction* have the same meaning. The definition of *perpetual conservation restriction* under this paragraph (b)(2) is not intended to preclude the deductibility of a donation of affirmative rights to use a land or water area under § 1.170A–13(d)(2). Any rights reserved by the donor in the donation of a perpetual conservation restriction must conform to the requirements of this section. See *e.g.,* paragraph (d)(4)(ii), (d)(5)(i), (e)(3), and (g)(4) of this section.

(c) *Qualified organization*—(1) *Eligible donee.* To be considered an eligible donee under this section, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. A conservation group organized or operated primarily or substantially for one of the conservation purposes specified in section 170(h)(4)(A) will be considered to have the commitment required by the preceding sentence. A qualified organization need not set aside funds to enforce the restrictions that are the subject of the contribution. For purposes of this section, the term *qualified organization* means:

(i) A governmental unit described in section 170(b)(1)(A)(v);

(ii) An organization described in section 170(b)(1)(A)(vi);

(iii) A charitable organization described in section 501(c)(3) that meets the public support test of section 509(a)(2);

(iv) A charitable organization described in section 501(c)(3) that meets the requirements of section 509(a)(3) and is controlled by an organization described in paragraphs (c)(1) (i), (ii), or (iii) of this section.

(2) *Transfers by donee.* A deduction shall be allowed for a contribution under this section only if in the instrument of conveyance the donor prohibits the donee from subsequently transferring the easement (or, in the case of a remainder interest or the reservation of a qualified mineral interest, the property), whether or not for consideration, unless the donee organization, as a condition of the subsequent transfer, requires that the conservation purposes which the contribution was originally intended to advance continue to be carried out. Moreover, subsequent transfers must be restricted to organizations qualifying, at the time of the subsequent transfer, as an eligible donee under paragraph (c)(1) of this section. When a later unexpected change in the conditions surrounding the property that is the subject of a donation under paragraph (b)(1), (2), or (3) of this section makes impossible or impractical the continued use of the property for conservation purposes, the requirement of this paragraph will be met if the property is sold or exchanged and any proceeds are used by the donee organization in a manner consistent with the conservation purposes of the original contribution. In the case of a donation under paragraph (b)(3) of this section to which the preceding sentence applies, see also paragraph (g)(5)(ii) of this section.

(d) *Conservation purposes*—(1) *In general.* For purposes of section 170(h) and this section, the term *conservation purposes* means—

(i) The preservation of land areas for outdoor recreation by, or the education of, the general public, within the meaning of paragraph (d)(2) of this section,

(ii) The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem, within the meaning of paragraph (d)(3) of this section,

(iii) The preservation of certain open space (including farmland and forest land) within the meaning of paragraph (d)(4) of this section, or

(iv) The preservation of a historically important land area or a certified historic structure, within the meaning of paragraph (d)(5) of this section.

(2) *Recreation or education*—(i) *In general.* The donation of a qualified real property interest to preserve land areas for the outdoor recreation of the general public or for the education of the general public will meet the conservation purposes test of this section. Thus, conservation purposes would include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for the use of the public.

(ii) *Access.* The preservation of land areas for recreation or education will not meet the test of this section unless the recreation or education is for the substantial and regular use of the general public.

(3) *Protection of environmental system*—(i) *In general.* The donation of a qualified real property interest to protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives will meet the conservation purposes test of this section. The fact that the habitat or environment has been altered to some extent by human activity will not result in a deduction being denied under this section if the fish, wildlife, or plants continue to exist there in a relatively natural state. For example, the preservation of a lake formed by a man-made dam or a salt pond formed by a man-made dike would meet the conservation purposes test if the lake or pond were a nature feeding

area for a wildlife community that included rare, endangered, or threatened native species.

(ii) *Significant habitat or ecosystem.* Significant habitats and ecosystems include, but are not limited to, habitats for rare, endangered, or threatened species of animal, fish, or plants; natural areas that represent high quality examples of a terrestrial community or aquatic community, such as islands that are undeveloped or not intensely developed where the coastal ecosystem is relatively intact; and natural areas which are included in, or which contribute to, the ecological viability of a local, state, or national park, nature preserve, wildlife refuge, wilderness area, or other similar conservation area.

(iii) *Access.* Limitations on public access to property that is the subject of a donation under this paragraph (d)(3) shall not render the donation nondeductible. For example, a restriction on all public access to the habitat of a threatened native animal species protected by a donation under this paragraph (d)(3) would not cause the donation to be nondeductible.

(4) *Preservation of open space*—(i) *In general.* The donation of a qualified real property interest to preserve open space (including farmland and forest land) will meet the conservation purposes test of this section if such preservation is—

(A) Pursuant to a clearly delineated Federal, state, or local governmental conservation policy and will yield a significant public benefit, or

(B) For the scenic enjoyment of the general public and will yield a significant public benefit.

An open space easement donated on or after December 18, 1980, must meet the requirements of section 170(h) in order to be deductible.

(ii) *Scenic enjoyment*—(A) *Factors.* A contribution made for the preservation of open space may be for the scenic enjoyment of the general public. Preservation of land may be for the scenic enjoyment of the general public if development of the property would impair the scenic character of the local rural or urban landscape or would interfere with a scenic panorama that can be enjoyed from a park, nature preserve, road, waterbody, trail, or historic structure or land area, and such area or transportation way is open to, or utilized by, the public. ''Scenic enjoyment'' will be evaluated by considering all pertinent facts and circumstances germane to the contribution. Regional variations in topography, geology, biology, and cultural and economic conditions require flexibility in the application of this test, but do not lessen the burden on the taxpayer to demonstrate the scenic characteristics of a donation under this paragraph. The application of a particular objective factor to help define a view as *scenic* in one setting may in fact be entirely inappropriate in another setting. Among the factors to be considered are:

(*1*) The compatibility of the land use with other land in the vicinity;

(*2*) The degree of contrast and variety provided by the visual scene;

(*3*) The openness of the land (which would be a more significant factor in an urban or densely populated setting or in a heavily wooded area);

(*4*) Relief from urban closeness;

(*5*) The harmonious variety of shapes and textures;

(*6*) The degree to which the land use maintains the scale and character of the urban landscape to preserve open space, visual enjoyment, and sunlight for the surrounding area;

(*7*) The consistency of the proposed scenic view with a methodical state scenic identification program, such as a state landscape inventory; and

(*8*) The consistency of the proposed scenic view with a regional or local landscape inventory made pursuant to a sufficiently rigorous review process, especially if the donation is endorsed by an appropriate state or local governmental agency.

(B) *Access.* To satisfy the requirement of scenic enjoyment by the general public, visual (rather than physical) access to or across the property by the general public is sufficient. Under the terms of an open space easement on scenic property, the entire property need not be visible to the public for a donation to qualify under this section, although the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is visible to the public.

(iii) *Governmental conservation policy*—(A) *In general.* The requirement that the preservation of open space be pursuant to a clearly delineated Federal, state, or local governmental policy is intended to protect the types of property identified by representatives of the general public as worthy of preservation or conservation. A general declaration of conservation goals by a single official or legislative body is not sufficient. However, a governmental conservation policy need not be a certification program that identifies particular lots or small parcels of individually owned property. This requirement will be met by donations that further a specific, identified conservation project, such as the preservation of land within a state or local landmark district that is locally recognized as being significant to that district; the preservation of a wild or scenic river, the preservation of farmland pursuant to a state program for flood prevention and control; or the protection of the scenic, ecological, or historic character of land that is contiguous to, or an integral part of, the surroundings of existing recreation or conservation sites. For example, the donation of a perpetual conservation restriction to a qualified organization pursuant to a formal resolution or certification by a local governmental agency established under state law specifically identifying the subject property as worthy of protection for conservation purposes will meet the requirement of this paragraph. A program need not be funded to satisfy this requirement, but the program must involve a significant commitment by the government with respect to the conservation project. For example, a governmental program according preferential tax assessment or preferential zoning for certain property deemed worthy of protection for conservation purposes would constitute a significant commitment by the government.

(B) *Effect of acceptance by governmental agency.* Acceptance of an easement by an agency of the Federal Government or by an agency of a state or local government (or by a commission, authority, or similar body duly constituted by the state or local government and acting on behalf of the state or local government) tends to establish the requisite clearly delineated governmental policy, although such acceptance, without more, is not sufficient. The more rigorous the review process by the governmental agency, the more the acceptance of the easement tends to establish the requisite clearly delineated governmental policy. For example, in a state where the legislature has established an Environmental Trust to accept gifts to the state which meet certain conservation purposes and to submit the gifts to a review that requires the approval of the state's highest officials, acceptance of a gift by the Trust tends to establish the requisite clearly delineated governmental policy. However, if the Trust merely accepts such gifts without a review process, the requisite clearly delineated governmental policy is not established.

(C) *Access.* A limitation on public access to property subject to a donation under this paragraph (d)(4)(iii) shall not render the deduction nondeductible unless the conservation purpose of the donation would be undermined or frustrated without public access. For example, a donation pursuant to a governmental policy to protect the scenic character of land near a river requires visual access to the same extent as would a donation under paragraph (d)(4)(ii) of this section.

(iv) *Significant public benefit*—(A) *Factors.* All contributions made for the preservation of open space must yield a significant public benefit. Public benefit will be evaluated by considering all pertinent facts and circumstances germane to the contribution. Factors germane to the evaluation of public benefit from one contribution may be irrelevant in determining public benefit from another contribution. No single factor will necessarily be determinative. Among the factors to be considered are:

(*1*) The uniqueness of the property to the area;

(*2*) The intensity of land development in the vicinity of the property (both existing development and foreseeable trends of development);

(*3*) The consistency of the proposed open space use with public programs (whether Federal, state or local) for conservation in the region, including programs for outdoor recreation, irrigation or water supply protection, water quality maintenance or enhancement, flood prevention and control, erosion control, shoreline protection, and protection of land areas included in, or related to, a government approved master plan or land management area;

(*4*) The consistency of the proposed open space use with existing private conservation programs in the area, as evidenced by other land, protected by easement or fee ownership by organizations referred to in §1.170A–14(c)(1), in close proximity to the property;

(*5*) The likelihood that development of the property would lead to or contribute to degradation of the scenic, natural, or historic character of the area;

(*6*) The opportunity for the general public to use the property or to appreciate its scenic values;

(*7*) The importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce to the area;

(*8*) The likelihood that the donee will acquire equally desirable and valuable substitute property or property rights;

(*9*) The cost to the donee of enforcing the terms of the conservation restriction;

(*10*) The population density in the area of the property; and

(*11*) The consistency of the proposed open space use with a legislatively mandated program identifying particular parcels of land for future protection.

(B) *Illustrations.* The preservation of an ordinary tract of land would not in and of itself yield a significant public benefit, but the preservation of ordinary land areas in conjunction with other factors that demonstrate significant public benefit or the preservation of a unique land area for public employment would yield a significant public benefit. For example, the preservation of a vacant downtown lot would not by itself yield a significant public benefit, but the preservation of the downtown lot as a public garden would, absent countervailing factors, yield a significant public benefit. The following are other examples of contributions which would, absent countervailing factors, yield a significant public benefit: The preservation of farmland pursuant to a state program for flood prevention and control; the preservation of a unique natural land formation for the enjoyment of the general public; the preservation of woodland along a public highway pursuant to a government program to preserve the appearance of the area so as to maintain the scenic view from the highway; and the preservation of a stretch of undeveloped property located between a public highway and the ocean in order to maintain the scenic ocean view from the highway.

(v) *Limitation.* A deduction will not be allowed for the preservation of open space under section 170(h)(4)(A)(iii), if the terms of the easement permit a degree of intrusion or future development that would interfere with the essential scenic quality of the land or with the governmental conservation policy that is being furthered by the donation. See §1.170A–14(e)(2) for rules relating to inconsistent use.

(vi) *Relationship of requirements*—(A) *Clearly delineated governmental policy and significant public benefit.* Although the requirements of ''clearly delineated governmental policy'' and ''significant public benefit'' must be met independently, for purposes of this section the two requirements may also be related. The more specific the governmental policy with respect to the particular site to be protected, the more likely the governmental decision, by itself, will tend to establish the significant public benefit associated with the donation. For example, while a statute in State X permitting preferential assessment for farmland is, by definition, governmental policy, it is distinguishable from a state statute, accompanied by appropriations, naming the X River as a valuable resource and articulating the legislative policy that the X River and the relatively natural quality of its surrounding be protected. On these facts, an open space easement on farmland in State X would have to demonstrate additional factors to establish ''significant public benefit.'' The specificity of the legislative mandate to protect the X River, however, would by itself tend to establish the significant public benefit associated with an open space easement on land fronting the X River.

(B) *Scenic enjoyment and significant public benefit.* With respect to the relationship between the requirements of ''scenic enjoyment'' and ''significant public benefit,'' since the degrees of scenic enjoyment offered by a variety of open space easements are subjective and not as easily delineated as are increasingly specific levels of governmental policy, the significant public benefit of preserving a scenic view must be independently established in all cases.

(C) *Donations may satisfy more than one test.* In some cases, open space easements may be both for scenic enjoyment and pursuant to a clearly delineated governmental policy. For example, the preservation of a particular scenic view identified as part of a scenic landscape inventory by a rigorous governmental review process will meet the tests of both paragraphs (d)(4)(i)(A) and (d)(4)(i)(B) of this section.

(5) *Historic preservation*—(i) *In general.* The donation of a qualified real property interest to preserve an historically important land area or a certified historic structure will meet the conservation purposes test of this section. When restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed under this section only if the terms of the restrictions require that such development conform with appropriate local, state, or Federal standards for construction or rehabilitation within the district. See also, §1.170A–14(h)(3)(ii).

(ii) *Historically important land area.* The term *historically important land area* includes:

(A) An independently significant land area including any related historic resources (for example, an archaeological site or a Civil War battlefield with related monuments, bridges, cannons, or houses) that meets the National Register Criteria for Evaluation in 36 CFR 60.4 (Pub. L. 89–665, 80 Stat. 915);

(B) Any land area within a registered historic district including any buildings on the land area that can reasonably be considered as contributing to the significance of the district; and

(C) Any land area (including related historic resources) adjacent to a property listed individually in the National Register of Historic Places (but not within a registered historic district) in a case where the physical or environmental features of the land area contribute to the historic or cultural integrity of the property.

(iii) *Certified historic structure.* The term *certified historic structure,* for purposes of this section, means any building, structure or land area which is—

(A) Listed in the National Register, or

(B) Located in a registered historic district (as defined in section 48(g)(3)(B)) and is certified by the Secretary of the Interior (pursuant to 36 CFR 67.4) to the Secretary of the Treasury as being of historic significance to the district.

A *structure* for purposes of this section means any structure, whether or not it is depreciable. Accordingly easements on private residences may qualify under this section. In addition, a structure would be considered to be a certified historic structure if it were certified either at the time the transfer was made or at the due date (including extensions) for filing the donor's return for the taxable year in which the contribution was made.

(iv) *Access.* (A) In order for a conservation contribution described in section 170(h)(4)(A)(iv) and this paragraph (d)(5) to be deductible, some visual public access to the donated property is required. In the case of an historically important land area, the entire property need not be visible to the public for a donation to qualify under this section. However, the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is so visible. Where the historic land area or certified historic structure which is the subject of the donation is not visible from a public way (*e.g.*, the structure is hidden from view by a wall or shrubbery, the structure is too far from the public way, or interior characteristics and features of the structure are the subject of the easement), the terms of the easement must be such that the general public is given the opportunity on a regular basis to view the characteristics and features of the property which are preserved by the easement to the extent consistent with the nature and condition of the property.

(B) Factors to be considered in determining the type and amount of public access required under paragraph (d)(5)(iv)(A) of this section include the historical significance of the donated property, the nature of the features that are the subject of the easement, the remoteness or accessibility of the site of the donated property, the possibility of physical hazards to the public visiting the property (for example, an unoccupied structure in a dilapidated condition), the extent to which public access would be an unreasonable intrusion on any privacy interests of individuals living on the property, the degree to which public access would impair the preservation interests which are the subject of the donation, and the availability of opportunities for the public to view the property by means other than visits to the site.

(C) The amount of access afforded the public by the donation of an easement shall be determined with reference to the amount of access permitted by the terms of the easement which are established by the donor, rather than the amount of access actually provided by the donee organization. However, if the donor is aware of any facts indicating that the amount of access that the donee organization will provide is significantly less than the amount of access permitted under the terms of the easement, then the amount of access afforded the public shall be determined with reference to this lesser amount.

(v) *Examples*. The provisions of paragraph (d)(5)(iv) of this section may be illustrated by the following examples:

Example 1. A and his family live in a house in a certified historic district in the State of X. The entire house, including its interior, has architectural features representing classic Victorian period architecture. A donates an exterior and interior easement on the property to a qualified organization but continues to live in the house with his family. A's house is surrounded by a high stone wall which obscures the public's view of it from the street. Pursuant to the terms of the easement, the house may be opened to the public from 10:00 a.m. to 4:00 p.m. on one Sunday in May and one Sunday in November each year for house and garden tours. These tours are to be under the supervision of the donee and open to members of the general public upon payment of a small fee. In addition, under the terms of the easement, the donee organization is given the right to photograph the interior and exterior of the house and distribute such photographs to magazines, newsletters, or other publicly available publications. The terms of the easement also permit persons affiliated with educational organizations, professional architectural associations, and historical societies to make an appointment through the donee organization to study the property. The donor is not aware of any facts indicating that the public access to be provided by the donee organization will be significantly less than that permitted by the terms of the easement. The 2 opportunities for public visits per year, when combined with the ability of the general public to view the architectural characteristics and features that are the subject of the easement through photographs, the opportunity for scholarly study of the property, and the fact that the house is used as an occupied residence, will enable the donation to satisfy the requirement of public access.

Example 2. B owns an unoccupied farmhouse built in the 1840's and located on a property that is adjacent to a Civil War battlefield. During the Civil War the farmhouse was used as quarters for Union troops. The battlefield is visited year round by the general public. The condition of the farmhouse is such that the safety of visitors will not be jeopardized and opening it to the public will not result in significant deterioration. The farmhouse is not visible from the battlefield or any public way. It is accessible only by way of a private road owned by B. B donates a conservation easement on the farmhouse to a qualified organization. The terms of the easement provide that the donee organization may open the property (via B's road) to the general public on four weekends each year from 8:30 a.m. to 4:00 p.m. The donation does not meet the public access requirement because the farmhouse is safe, unoccupied, and easily accessible to the general public who have come to the site to visit Civil War historic land areas (and related resources), but will only be open to the public on four weekends each year. However, the donation would meet the public access requirement if the terms of the easement permitted the donee organization to open the property to the public every other weekend during the year and the donor is not aware of any facts indicating that the donee organization will provide significantly less access than that permitted.

(e) *Exclusively for conservation purposes*—(1) *In general*. To meet the requirements of this section, a donation must be exclusively for conservation purposes. See paragraphs (c)(1) and (g)(1) through (g)(6)(ii) of this section. A deduction will not be denied under this section when incidental benefit inures to the donor merely as a result of conservation restrictions limiting the uses to which the donor's property may be put.

(2) *Inconsistent use.* Except as provided in paragraph (e)(4) of this section, a deduction will not be allowed if the contribution would accomplish one of the enumerated conservation purposes but would permit destruction of other significant conservation interests. For example, the preservation of farmland pursuant to a State program for flood prevention and control would not qualify under paragraph (d)(4) of this section if under the terms of the contribution a significant naturally occurring ecosystem could be injured or destroyed by the use of pesticides in the operation of the farm. However, this requirement is not intended to prohibit uses of the property, such as selective timber harvesting or selective farming if, under the circumstances, those uses do not impair significant conservation interests.

(3) *Inconsistent use permitted.* A use that is destructive of conservation interests will be permitted only if such use is necessary for the protection of the conservation interests that are the subject of the contribution. For example, a deduction for the donation of an easement to preserve an archaeological site that is listed on the National Register of Historic Places will not be disallowed if site excavation consistent with sound archaeological practices may impair a scenic view of which the land is a part. A donor may continue a pre-existing use of the property that does not conflict with the conservation purposes of the gift.

(f) *Examples.* The provisions of this section relating to conservation purposes may be illustrated by the following examples.

Example 1. State S contains many large tract forests that are desirable recreation and scenic areas for the general public. The forests' scenic values attract millions of people to the State. However, due to the increasing intensity of land development in State S, the continued existence of forestland parcels greater than 45 acres is threatened. J grants a perpetual easement on a 100-acre parcel of forestland that is part of one of the State's scenic areas to a qualifying organization. The easement imposes restrictions on the use of the parcel for the purpose of maintaining its scenic values. The restrictions include a requirement that the parcel be maintained forever as open space devoted exclusively to conservation purposes and wildlife protection, and that there be no commercial, industrial, residential, or other development use of such parcel. The law of State S recognizes a limited public right to enter private land, particularly for recreational pursuits, unless such land is posted or the landowner objects. The easement specifically restricts the landowner from posting the parcel, or from objecting, thereby maintaining public access to the parcel according to the custom of the State. J's parcel provides the opportunity for the public to enjoy the use of the property and appreciate its scenic values. Accordingly, J's donation qualifies for a deduction under this section.

Example 2. A qualified conservation organization owns Greenacre in fee as a nature preserve. Greenacre contains a high quality example of a tall grass prairie ecosystem. Farmacre, an operating farm, adjoins Greenacre and is a compatible buffer to the nature preserve. Conversion of Farmacre to a more intense use, such as a housing development, would adversely affect the continued use of Greenacre as a nature preserve because of human traffic generated by the development. The owner of Farmacre donates an easement preventing any future development on Farmacre to the qualified conservation organization for conservation purposes. Normal agricultural uses will be allowed on Farmacre. Accordingly, the donation qualifies for a deduction under this section.

Example 3. H owns Greenacre, a 900-acre parcel of woodland, rolling pasture, and orchards on the crest of a mountain. All of Greenacre is clearly visible from a nearby national park. Because of the strict enforcement of an applicable zoning plan, the highest and best use of Greenacre is as a subdivision of 40-acre tracts. H wishes to donate a scenic easement on Greenacre to a qualifying conservation organization, but H would like to reserve the right to subdivide Greenacre into 90-acre parcels with no more than one single-family home allowable on each parcel. Random building on the property, even as little as one home for each 90 acres, would destroy the scenic character of the view. Accordingly, no deduction would be allowable under this section.

Example 4. Assume the same facts as in *example (3),* except that not all of Greenacre is visible from the park and the deed of easement allows for limited cluster development of no more than five nine-acre clusters (with four houses on each cluster) located in areas generally not visible from the national park and subject to site and building plan approval by the donee organization in order to preserve the scenic view from the park. The donor and the donee have already identified sites where limited cluster development would not be visible from the park or would not impair the view. Owners of homes in the clusters will not have any rights with respect to the surrounding Greenacre property that are not also available to the general public. Accordingly, the donation qualifies for a deduction under this section.

Example 5. In order to protect State S's declining open space that is suited for agricultural use from increasing development pressure that has led to a marked decline in such open space, the Legislature of State S passed a statute authorizing the purchase of ''agricultural land development rights'' on open acreage. Agricultural land development rights allow the State to place agricultural preservation restrictions on land designated as worthy of protection in order to preserve open space and farm resources. Agricultural preservation restrictions prohibit or limit construction or placement of buildings except those used for agricultural purposes or dwellings used for family living by the farmer and his family and employees; removal of mineral substances in any manner that adversely affects the land's agricultural potential; or other uses detrimental to retention of the land for agricultural use. Money has been appropriated for this program and some landowners have in fact sold their ''agricultural land development rights'' to State S. K owns and operates a small dairy farm in State S located in an area designated by the Legislature as worthy of protection. K desires to preserve his farm for agricultural purposes in perpetuity. Rather than selling the development rights to State S, K grants to a qualified organization an agricultural preservation restriction on his property in the form of a conservation easement. K reserves to himself, his heirs and assigns the right to manage the farm consistent with sound agricultural and management practices. The preservation of K's land is pursuant to a clearly delineated governmental policy of preserving open space available for agricultural use, and will yield a significant public benefit by preserving open space against increasing development pressures.

(g) *Enforceable in perpetuity*—(1) *In general.* In the case of any donation under this section, any interest in the property retained by the donor (and the donor's successors in interest) must be subject to legally enforceable restrictions (for example, by recordation in the land records of the jurisdiction in which the property is located) that will prevent uses of the retained interest inconsistent with the conservation purposes of the donation. In the case of a contribution of a remainder interest, the contribution will not qualify if the tenants, whether they are tenants for life or a term of years, can use the property in a manner that diminishes the conservation values which are intended to be protected by the contribution.

(2) *Protection of a conservation purpose in case of donation of property subject to a mortgage.* In the case of conservation contributions made after February 13, 1986, no deducion will be permitted under this section for an interest in property which is subject to a mortgage unless the mortgagee subordinates its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity. For conservation contributions made prior to February 14, 1986, the requirement of section 170 (h)(5)(A) is satisfied in the case of mortgaged property (with respect to which the mortgagee has not subordinated its rights) only if the donor can demonstrate that the conservation purpose is protected in perpetuity without subordination of the mortgagee's rights.

(3) *Remote future event.* A deduction shall not be disallowed under section 170(f)(3)(B)(iii) and this section merely because the interest which passes to, or is vested in, the donee organization may be defeated by the performance of some act or the happening of some event, if on the date of the gift it appears that the possibility that such act or event will occur is so remote as to be negligible. See paragraph (e) of §1.170A–1. For example, a state's statutory requirement that use restrictions must be rerecorded every 30 years to remain enforceable shall not, by itself, render an easement nonperpetual.

(4) *Retention of qualified mineral interest*—(i) *In general.* Except as otherwise provided in paragraph (g)(4)(ii) of this section, the requirements of this section are not met and no deduction shall be allowed in the case of a contribution of any interest when there is a retention by any person of a qualified mineral interest (as defined in paragraph (b)(1)(i) of this section) if at any time there may be extractions or removal of

minerals by any surface mining method. Moreover, in the case of a qualified mineral interest gift, the requirement that the conservation purposes be protected in perpetuity is not satisfied if any method of mining that is inconsistent with the particular conservation purposes of a contribution is permitted at any time. See also §1.170A–14(e)(2). However, a deduction under this section will not be denied in the case of certain methods of mining that may have limited, localized impact on the real property but that are not irremediably destructive of significant conservation interests. For example, a deduction will not be denied in a case where production facilities are concealed or compatible with existing topography and landscape and when surface alteration is to be restored to its original state.

(ii) *Exception for qualified conservation contributions after July 1984.* (A) A contribution made after July 18, 1984, of a qualified real property interest described in section 170(h)(2)(A) shall not be disqualified under the first sentence of paragraph (g)(4)(i) of this section if the following requirements are satisfied.

(*1*) The ownership of the surface estate and mineral interest were separated before June 13, 1976, and remain so separated up to and including the time of the contribution.

(*2*) The present owner of the mineral interest is not a person whose relationship to the owner of the surface estate is described at the time of the contribution in section 267(b) or section 707(b), and

(*3*) The probability of extraction or removal of minerals by any surface mining method is so remote as to be negligible.

Whether the probability of extraction or removal of minerals by surface mining is so remote as to be negligible is a question of fact and is to be made on a case by case basis. Relevant factors to be considered in determining if the probability of extraction or removal of minerals by surface mining is so remote as to be negligible include: Geological, geophysical or economic data showing the absence of mineral reserves on the property, or the lack of commercial feasibility at the time of the contribution of surface mining the mineral interest.

(B) If the ownership of the surface estate and mineral interest first became separated after June 12, 1976, no deduction is permitted for a contribution under this section unless surface mining on the property is completely prohibited.

(iii) *Examples.* The provisions of paragraph (g)(4)(i) and (ii) of this section may be illustrated by the following examples:

Example 1. K owns 5,000 acres of bottomland hardwood property along a major watershed system in the southern part of the United States. Agencies within the Department of the Interior have determined that southern bottomland hardwoods are a rapidly diminishing resource and a critical ecosystem in the south because of the intense pressure to cut the trees and convert the land to agricultural use. These agencies have further determined (and have indicated in correspondence with K) that bottomland hardwoods provide a superb habitat for numerous species and play an important role in controlling floods and purifying rivers. K donates to a qualified organization his entire interest in this property other than his interest in the gas and oil deposits that have been identified under K's property. K covenants and can ensure that, although drilling for gas and oil on the property may have some temporary localized impact on the real property, the drilling will not interfere with the overall conservation purpose of the gift, which is to protect the unique bottomland hardwood ecosystem. Accordingly, the donation qualifies for a deduction under this section.

Example 2. Assume the same facts as in *Example 1,* except that in 1979, K sells the mineral interest to A, an unrelated person, in an arm's-length transaction, subject to a recorded prohibition on the removal of any minerals by any surface mining method and a recorded prohibition against any mining technique that will harm the bottomland hardwood ecosystem. After the sale to A, K donates a qualified real property interest to a qualified organization to protect the bottomland hardwood ecosystem. Since at the time of the transfer, surface mining and any mining technique that will harm the bottomland hardwood ecosystem are completely prohibited, the donation qualifies for a deduction under this section.

(5) *Protection of conservation purpose where taxpayer reserves certain rights*—(i) *Documentation.* In the case of a donation made after February 13, 1986, of any qualified real property interest

when the donor reserves rights the exercise of which may impair the conservation interests associated with the property, for a deduction to be allowable under this section the donor must make available to the donee, prior to the time the donation is made, documentation sufficient to establish the condition of the property at the time of the gift. Such documentation is designed to protect the conservation interests associated with the property, which although protected in perpetuity by the easement, could be adversely affected by the exercise of the reserved rights. Such documentation may include:

(A) The appropriate survey maps from the United States Geological Survey, showing the property line and other contiguous or nearby protected areas;

(B) A map of the area drawn to scale showing all existing man-made improvements or incursions (such as roads, buildings, fences, or gravel pits), vegetation and identification of flora and fauna (including, for example, rare species locations, animal breeding and roosting areas, and migration routes), land use history (including present uses and recent past disturbances), and distinct natural features (such as large trees and aquatic areas);

(C) An aerial photograph of the property at an appropriate scale taken as close as possible to the date the donation is made; and

(D) On-site photographs taken at appropriate locations on the property. If the terms of the donation contain restrictions with regard to a particular natural resource to be protected, such as water quality or air quality, the condition of the resource at or near the time of the gift must be established. The documentation, including the maps and photographs, must be accompanied by a statement signed by the donor and a representative of the donee clearly referencing the documentation and in substance saying ''This natural resources inventory is an accurate representation of [the protected property] at the time of the transfer.''.

(ii) *Donee's right to inspection and legal remedies.* In the case of any donation referred to in paragraph (g)(5)(i) of this section, the donor must agree to notify the donee, in writing, before exercising any reserved right, *e.g.* the right to extract certain minerals which may have an adverse impact on the conservation interests associated with the qualified real property interest. The terms of the donation must provide a right of the donee to enter the property at reasonable times for the purpose of inspecting the property to determine if there is compliance with the terms of the donation. Additionally, the terms of the donation must provide a right of the donee to enforce the conservation restrictions by appropriate legal proceedings, including but not limited to, the right to require the restoration of the property to its condition at the time of the donation.

(6) *Extinguishment.* (i) In general. If a subsequent unexpected change in the conditions surrounding the property that is the subject of a donation under this paragraph can make impossible or impractical the continued use of the property for conservation purposes, the conservation purpose can nonetheless be treated as protected in perpetuity if the restrictions are extinguished by judicial proceeding and all of the donee's proceeds (determined under paragraph (g)(6)(ii) of this section) from a subsequent sale or exchange of the property are used by the donee organization in a manner consistent with the conservation purposes of the original contribution.

(ii) *Proceeds.* In case of a donation made after February 13, 1986, for a deduction to be allowed under this section, at the time of the gift the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift, bears to the value of the property as a whole at that time. See § 1.170A–14(h)(3)(iii) relating to the allocation of basis. For purposes of this paragraph (g)(6)(ii), that proportionate value of the donee's property rights shall remain constant. Accordingly, when a change in conditions give rise to the extinguishment of a perpetual conservation restriction under paragraph (g)(6)(i) of this section, the donee organization, on a subsequent sale, exchange, or involuntary conversion of the subject property, must be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction.

(h) *Valuation*—(1) *Entire interest of donor other than qualified mineral interest.* The value of the contribution under section 170 in the case of a contribution of a taxpayer's entire interest in property other than a qualified mineral interest is the fair market value of the surface rights in the property contributed. The value of the contribution shall be computed without regard to the mineral rights. See paragraph (h)(4), *example (1)*, of this section.

(2) *Remainder interest in real property.* In the case of a contribution of any remainder interest in real property, section 170(f)(4) provides that in determining the value of such interest for purposes of section 170, depreciation and depletion of such property shall be taken into account. See §1.170A–12. In the case of the contribution of a remainder interest for conservation purposes, the current fair market value of the property (against which the limitations of §1.170A–12 are applied) must take into account any pre-existing or contemporaneously recorded rights limiting, for conservation purposes, the use to which the subject property may be put.

(3) *Perpetual conservation restriction*—(i) *In general.* The value of the contribution under section 170 in the case of a charitable contribution of a perpetual conservation restriction is the fair market value of the perpetual conservation restriction at the time of the contribution. See §1.170A–7(c). If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the fair market value of the donated easement is based on the sales prices of such comparable easements. If no substantial record of market-place sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the fair market value of a perpetual conservation restriction is equal to the difference between the fair market value of the property it encumbers before the granting of the restriction and the fair market value of the encumbered property after the granting of the restriction. The amount of the deduction in the case of a charitable contribution of a perpetual conservation restriction covering a portion of the contiguous property owned by a donor and the donor's family (as defined in section 267(c)(4)) is the difference between the fair market value of the entire contiguous parcel of property before and after the granting of the restriction. If the granting of a perpetual conservation restriction after January 14, 1986, has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the deduction for the conservation contribution shall be reduced by the amount of the increase in the value of the other property, whether or not such property is contiguous. If, as a result of the donation of a perpetual conservation restriction, the donor or a related person receives, or can reasonably expect to receive, financial or economic benefits that are greater than those that will inure to the general public from the transfer, no deduction is allowable under this section. However, if the donor or a related person receives, or can reasonably expect to receive, a financial or economic benefit that is substantial, but it is clearly shown that the benefit is less than the amount of the transfer, then a deduction under this section is allowable for the excess of the amount transferred over the amount of the financial or economic benefit received or reasonably expected to be received by the donor or the related person. For purposes of this paragraph (h)(3)(i), related person shall have the same meaning as in either section 267(b) or section 707(b). (See *Example 10* of paragraph (h)(4) of this section.)

(ii) *Fair market value of property before and after restriction.* If before and after valuation is used, the fair market value of the property before contribution of the conservation restriction must take into account not only the current use of the property but also an objective assessment of how immediate or remote the likelihood is that the property, absent the restriction, would in fact be developed, as well as any effect from zoning, conservation, or historic preservation laws that already restrict the property's potential highest and best use. Further, there may be instances where the grant of a conservation restriction may have no material effect on the value of the property or may in fact serve to enhance, rather than reduce, the value of property. In such instances no deduction would be allowable. In the case of a conservation restriction that allows for any development, however limited, on the property to be protected, the fair maket value of the property after contribution of the restriction must take into account the effect of the development. In the case of a conservation easement such as an easement on a certified historic structure, the fair market value of the property after contribution of the restriction must take into account the amount of access permitted by the terms of the easement. Additionally, if before and after valuation is used, an appraisal of the property after contribution of the restriction must take into account the effect of restrictions that will result in a reduction of the potential fair market value represented by highest and best use but will, nevertheless, permit uses of the property that will increase its fair market value above that represented by the property's current use. The value of a perpetual conservation restriction shall not be reduced by reason of the existence of restrictions on transfer designed solely to ensure that the conservation restriction will be dedicated to conservation purposes. See § 1.170A–14 (c)(3).

(iii) *Allocation of basis.* In the case of the donation of a qualified real property interest for conservation purposes, the basis of the property retained by the donor must be adjusted by the elimination of that part of the total basis of the property that is properly allocable to the qualified real property interest granted. The amount of the basis that is allocable to the qualified real property interest shall bear the same ratio to the total basis of the property as the fair market value of the qualified real property interest bears to the fair market value of the property before the granting of the qualified real property interest. When a taxpayer donates to a qualifying conservation organization an easement on a structure with respect to which deductions are taken for depreciation, the reduction required by this paragraph (h)(3)(ii) in the basis of the property retained by the taxpayer must be allocated between the structure and the underlying land.

(4) *Examples.* The provisions of this section may be illustrated by the following examples. In examples illustrating the value or deductibility of donations, the applicable restrictions and limitations of § 1.170A–4, with respect to reduction in amount of charitable contributions of certain appreciated property, and § 1.170A–8, with respect to limitations on charitable deductions by individuals. must also be taken into account.

(i) *Example 1.* A owns Goldacre, a property adjacent to a state park. A wants to donate Goldacre to the state to be used as part of the park, but A wants to reserve a qualified mineral interest in the property, to exploit currently and to devise at death. The fair market value of the surface rights in Goldacre is $200,000 and the fair market value of the mineral rights in $100.000. In order to ensure that the quality of the park will not be degraded, restrictions must be imposed on the right to extract the minerals that reduce the fair market value of the mineral rights to $80,000. Under this section, the value of the contribution is $200,000 (the value of the surface rights).

(ii) *Example 2.* In 1984 B, who is 62, donates a remainder interest in Greenacre to a qualifying organization for conservation purposes, retaining an interest for B's life. Greenacre is a tract of 200 acres of undeveloped woodland that is valued at $200,000 at its highest and best use. Under § 1.170A–12(b), the value of a remainder interest in real property following one life is determined under § 25.2512–5 of this chapter (Gift Tax Regulations). (See § 25.2512–5A of this chapter with respect to the valuation of annuities, interests for life or a term of years, and remainder or reversionary interests transferred before June 1, 2023.) For transfers occurring after November 30, 1983, and before May 1, 1989, the single life remainder factors, valued at 10 percent, can be found in Table A of § 20.2031–7A(d)(6) of this chapter. The remainder factor under these facts is 0.27998. Accordingly, the value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is $55,996 ($200,000 × 0.27998).

(iii) *Example 3.* Assume the same facts as in paragraph (h)(4)(ii) of this section (*Example 2*) except that Greenacre is B's 200-acre estate with a home built during the colonial period. Some of the acreage around the home is cleared; the balance of Greenacre, except for access roads, is wooded and undeveloped. See section 170(f)(3)(B)(i). However, B would like Greenacre to be maintained in its current state after his death, so he donates a remainder interest in Greenacre to a qualifying organization for conservation purposes pursuant to section 170 (f)(3)(B)(iii) and (h)(2)(B). At the time of the gift the land has a value of $200,000 and the house has a value of $100,000. The value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is computed pursuant to § 1.170A–12. See § 1.170A–12(b)(3).

(iv) *Example 4.* Assume the same facts as in paragraph (h)(4)(ii) of this section (*Example 2*) except that at age 62 instead of donating a remainder interest B donates an easement in Greenacre to a qualifying organization for conservation purposes. The fair market value of Greenacre after the donation is reduced to $110,000. Accordingly, the value of the easement, and thus the amount eligible for a deduction under section 170(f), is $90,000 ($200,000 less $110,000).

(v) *Example 5.* Assume the same facts as in paragraph (h)(4)(iv) of this section (*Example 4*) and assume that three years later, at age 65, B decides to donate a remainder interest in Greenacre to a qualifying organization for conservation purposes. Increasing real estate values in the area have raised the fair market value of Greenacre (subject to the easement) to $130,000. Accordingly, the value of the remainder interest, and thus the amount eligible for a deduction under section 170(f), is $41,639 ($130,000 × .32030).

(vi) *Example 6.* Assume the same facts as in paragraph (h)(2)(ii) of this section (*Example 2*) except that at the time of the donation of a remainder interest in Greenacre, B also donates an easement to a different qualifying organization for conservation purposes. Based on all the facts and circumstances, the value of the easement is determined to be $100,000. Therefore, the value of the property after the easement is $100,000 and the value of the remainder interest, and thus the amount eligible for deduction under section 170(f), is $27,998 ($100,000 × .27998).

(vii) *Example 7.* C owns Greenacre, a 200-acre estate containing a house built during the colonial period. At its highest and best use, for home development, the fair market value of Greenacre is $300,000. C donates an easement (to maintain the house and Green acre in their current state) to a qualifying organization for conservation purposes. The fair market value of Greenacre after the donation is reduced to $125,000. Accordingly, the value of the easement and the amount eligible for a deduction under section 170(f) is $175.000 ($300,000 less $125,000).

(viii) *Example 8.* Assume the same facts as in paragraph (h)(4)(vii) of this section (*Example 7*) and assume that three years later, C decides to donate a remainder interest in Greenacre to a qualifying organization for conservation purposes. Increasing real estate values in the area have raised the fair market value of Greenacre to $180.000. Assume that because of the perpetual easement prohibiting any development of the land, the value of the house is $120,000 and the value of the land is $60,000. The value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is computed pursuant to § 1.170A–12. See § 1.170A–12(b)(3).

(ix) *Example 9.* D owns property with a basis of $20,000 and a fair market value of $80,000. D donates to a qualifying organization an easement for conservation purposes that is determined under this section to have a fair market value of $60,000. The amount of basis allocable to the easement is

$15,000 ($60,000/$80,000 = $15,000/$20,000). Accordingly, the basis of the property is reduced to $5,000 ($20,000 minus $15,000)

(x) *Example 10.* E owns 10 one-acre lots that are currently woods and parkland. The fair market value of each of E's lots is $15,000 and the basis of each lot is $3,000. E grants to the county a perpetual easement for conservation purposes to use and maintain eight of the acres as a public park and to restrict any future development on those eight acres. As a result of the restrictions, the value of the eight acres is reduced to $1,000 an acre. However, by perpetually restricting development on this portion of the land, E has ensured that the two remaining acres will always be bordered by parkland, thus increasing their fair market value to $22,500 each. If the eight acres represented all of E's land, the fair market value of the easement would be $112,000, an amount equal to the fair market value of the land before the granting of the easement (8 × $15,000 = $120,000) minus the fair market value of the encumbered land after the granting of the easement (8 × $1,000 = $8,000). However, because the easement only covered a portion of the taxpayer's contiguous land, the amount of the deduction under section 170 is reduced to $97,000 ($150,000–$53,000), that is, the difference between the fair market value of the entire tract of land before ($150,000) and after ((8 × $1,000) + (2 × $22,500)) the granting of the easement.

(xi) *Example 11.* Assume the same facts as in paragraph (h)(4)(x) of this section (*Example 10*) Since the easement covers a portion of E's land, only the basis of that portion is adjusted. Therefore, the amount of basis allocable to the easement is $22,400 ((8 × $3,000) × ($112,000/$120,000)). Accordingly, the basis of the eight acres encumbered by the easement is reduced to $1,600 ($24,000–$22,400), or $200 for each acre. The basis of the two remaining acres is not affected by the donation.

(xii) *Example 12.* F owns and uses as professional offices a two-story building that lies within a registered historic district. F's building is an outstanding example of period architecture with a fair market value of $125,000. Restricted to its current use, which is the highest and best use of the property without making changes to the facade, the building and lot would have a fair market value of $100,000, of which $80,000 would be allocable to the building and $20,000 woud be allocable to the lot. F's basis in the property is $50,000, of which $40,000 is allocable to the building and $10,000 is allocable to the lot. F's neighborhood is a mix of residential and commercial uses, and it is possible that F (or another owner) could enlarge the building for more extensive commercial use, which is its highest and best use. However, this would require changes to the facade. F would like to donate to a qualifying preservation organization an easement restricting any changes to the facade and promising to maintain the facade in perpetuity. The donation would qualify for a deduction under this section. The fair market value of the easement is $25,000 (the fair market value of the property before the easement, $125,000, minus the fair market value of the property after the easement, $100,000). Pursuant to §1.170A–14(h)(3)(iii), the basis allocable to the easement is $10,000 and the basis of the underlying property (building and lot) is reduced to $40,000.

(i) *Substantiation requirement.* If a taxpayer makes a qualified conservation contribution and claims a deduction, the taxpayer must maintain written records of the fair market value of the underlying property before and after the donation and the conservation purpose furthered by the donation, and such information shall be stated in the taxpayer's income tax return if required by the return or its instructions. See also §1.170A–13(c) (relating to substantiation requirements for deductions in excess of $5,000 for charitable contributions made on or before July 30, 2018); §1.170A–16(d) (relating to substantiation of charitable contributions of more than $5,000 made after July 30, 2018); §1.170A–17 (relating to the definitions of qualified appraisal and qualified appraiser for substantiation of contributions made on or after January 1, 2019); and section 6662 (relating to the imposition of an accuracy-related penalty on underpayments). Taxpayers may rely on the rules in §1.170A–16(d) for contributions made after June 3, 2004, or appraisals prepared for returns or submissions filed after August 17, 2006. Taxpayers may rely on the rules in §1.170A–17 for appraisals prepared for returns or submissions filed after August 17, 2006.

(j) *Disallowance of certain deductions for contributions by partnerships and S corporations that exceed 2.5 times the sum of the relevant bases*—(1) *In general.* This paragraph (j) applies the rules of section 170(h)(7), which disallow a deduction for certain qualified conservation contributions, as defined in section 170(h)(1) and this section, made by, or allocated to, partnerships or S corporations (as defined in section 1361(a)(1) of the Code) if the amount of the qualified conservation contribution exceeds 2.5 times the sum of the relevant bases as determined by this paragraph (j) and paragraphs (k) through (m) of this section (Disallowance Rule). The Disallowance Rule does not apply to qualified conservation contributions made directly by landowners that are not pass-through entities, such as individuals or C corporations. *See* paragraph (n) of this section for certain exceptions. *See* paragraph (j)(3) of this section for definitions of terms used in this paragraph (j) and paragraphs (k) through (n) of this section.

(2) *Application*—(i) *Contributing partnerships and contributing S corporations.* Except as provided in paragraph (n) of this section, a qualified conservation contribution by a contributing partnership or a contributing S corporation is a disallowed qualified conservation contribution if the amount of the qualified conservation contribution exceeds 2.5 times the sum of each of the contributing partnership's or contributing S corporation's ultimate member's relevant basis as determined under this paragraph (j) and paragraphs (k) through (m) of this section.

(ii) *Upper-tier partnerships and upper-tier S corporations.* Except as provided in paragraph (n) of this section, an allocated portion received by an upper-tier partnership or upper-tier S corporation is a disallowed qualified conservation contribution if either the contribution is a disallowed qualified conservation contribution with respect to the partnership that allocated the allocated portion to the upper-tier partnership or upper-tier S corporation, or such allocated portion exceeds 2.5 times the sum of each of that upper-tier partnership's or upper-tier S corporation's ultimate member's relevant basis as determined under this paragraph (j) and paragraphs (k) through (m) of this section.

(iii) *Partner or S corporation shareholder claiming an inconsistent amount.* If a partner or S corporation shareholder claims an amount of qualified conservation contribution that is inconsistent with and greater than the partner's distributive share or S corporation shareholder's pro rata share of qualified conservation contribution reported to the partner or S corporation shareholder by the partnership or S corporation, predicated on a position that the partnership's or S corporation's qualified conservation contribution was a greater amount than the amount claimed by the partnership or S corporation, and the qualified conservation contribution would have been a disallowed qualified conservation contribution if the partnership or S corporation had actually claimed that greater amount, then the partner's or S corporation shareholder's claimed qualified conservation contribution is a disallowed qualified conservation contribution.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (j) and paragraphs (k) through (n) of this section:

(i) *Allocated portion.* In the case of an upper-tier partnership or upper-tier S corporation that receives, directly or indirectly, a distributive share of a qualified conservation contribution, the phrase *allocated portion* means the amount of such distributive share.

(ii) *Amount of qualified conservation contribution.* The amount of a contributing partnership's or contributing S corporation's qualified conservation contribution is the amount claimed as a qualified conservation contribution on the return of the contributing partnership or contributing S corporation for the taxable year in which the contribution is made. If the contributing partnership or contributing S corporation files an amended return or administrative adjustment request under section 6227 of the Code claiming a higher amount with respect to the qualified conservation contribution, the rules of this section must be re-applied with respect to such higher amount to determine the application of section 170(h)(7) and this section; for example, if a contributing S corporation's original return claims a qualified conservation contribution that does not exceed 2.5 times the sum of the relevant bases, and the S corporation subsequently files an amended return claiming a higher amount with respect to the qualified conservation contribution that does exceed 2.5 times the sum of the relevant bases, then the entire amount of the qualified conservation contribution is a disallowed qualified conservation contribution (unless one of the exceptions in paragraph (n) of this section applies). If the contributing partnership or contributing S corporation files an amended return or timely administrative adjustment request under section 6227 claiming a lower amount with respect to the qualified conservation contribution, the rules of this section will be re-applied with respect to such lower amount to determine the application of section 170(h)(7) and this section if and only if the amended return or timely administrative adjustment request is filed before the contributing partnership or contributing S corporation is put on notice of an IRS examination with respect to the qualified conservation contribution. A contributing partnership or contributing S corporation is considered to be on notice after the earlier of—

(A) The date the contributing partnership or contributing S corporation is first contacted by the Internal Revenue Service in connection with any examination of a return that relates to the qualified conservation contribution; or

(B) The date any person is first contacted by the Internal Revenue Service concerning an examination of that person under section 6700 (relating to the penalty for promoting abusive tax shelters) for an activity that relates to the qualified conservation contribution.

(iii) *Contributing partnership.* The term *contributing partnership* means a partnership that makes a qualified conservation contribution.

(iv) *Contributing S corporation.* The term *contributing S corporation* means an S corporation that makes a qualified conservation contribution.

(v) *Direct interest.* The term *direct interest* refers to an ownership interest in a contributing partnership, upper-tier partnership, contributing S corporation, or upper-tier S corporation that is held directly, or through an entity disregarded as separate from its owner for Federal income tax purposes, a qualified subchapter S subsidiary as defined in section 1361(b)(3), or through a grantor trust (under subpart E of part 1 of subchapter J of chapter 1 of the Code). In the case of a partner that is a C corporation (as defined in section 1361(a)(2)), non-grantor trust, or an estate, or an S corporation shareholder that is a non-grantor trust or an estate, the *direct interest* in the partnership or S corporation, as applicable, is held by the C corporation, non-grantor trust, or estate; the C corporation's shareholders, trust beneficiaries, and estate beneficiaries are not considered to hold any interest in the partnership or S corporation, as applicable, for purposes of this paragraph (j) and paragraphs (k) through (n) of this section.

(vi) *Directly.* An ownership interest is held *directly* if it is not held through one or more upper-tier partnerships or upper-tier S corporations. A distributive share or pro rata share of a qualified conservation contribution is received *directly* if it does not pass through one or more upper-tier partnerships or upper-tier S corporations.

(vii) *Disallowed qualified conservation contribution.* The term *disallowed qualified conservation contribution* means a qualified conservation contribution or allocated portion for which no deduction is allowed pursuant to section 170(h)(7) and this paragraph (j).

(viii) *Indirect interest.* The term *indirect interest* refers to an ownership interest in a contributing partnership, contributing S corporation, upper-tier partnership, or upper-tier S corporation held through an upper-tier S corporation or one or more upper-tier partnerships.

(ix) *Indirectly.* An ownership interest is held *indirectly* if it is held through one or more upper-tier partnerships or upper-tier S corporations. A distributive share or pro rata share of a qualified conservation contribution is received *indirectly* if it passes through one or more upper-tier partnerships or upper-tier S corporations.

(x) *Ultimate member*. The term *ultimate member* means, with respect to any partnership or S corporation, any partner (that is not itself a partnership or S corporation) or S corporation shareholder that receives a distributive share or pro rata share, directly or indirectly, of a qualified conservation contribution. Thus, ultimate members will either be partners holding a direct interest in a partnership, which may be the contributing partnership or an upper-tier partnership, or shareholders holding a direct interest in an S corporation, which may be the contributing S corporation or an upper-tier S corporation. Upper-tier S corporations and upper-tier partnerships themselves are not considered ultimate members.

(xi) *Upper-tier partnership*. The term *upper-tier partnership* means a partnership that receives an allocated portion.

(xii) *Upper-tier S corporation*. The term *upper-tier S corporation* means an S corporation that receives an allocated portion.

(4) *Effect of Disallowance Rule*—(i) *If the Disallowance Rule applies to a contributing partnership or contributing S corporation*. If a contributing partnership's or contributing S corporation's qualified conservation contribution is a disallowed qualified conservation contribution under this paragraph (j), then:

(A) Any upper-tier partnership's or upper-tier S corporation's allocated portion of such contribution is a disallowed qualified conservation contribution, regardless of whether such allocated portion exceeds 2.5 times the sum of each of the upper-tier partnership's or upper-tier S corporation's ultimate member's relevant basis; and

(B) No person (whether holding a direct or indirect interest in such contributing partnership or contributing S corporation) may claim a deduction under any provision of the Code with respect to any amount of such disallowed qualified conservation contribution, regardless of whether that person's distributive share or pro rata share of the disallowed qualified conservation contribution exceeds 2.5 times its relevant basis.

(ii) *If the Disallowance Rule does not apply to a contributing partnership or contributing S corporation*. If a contributing partnership's or contributing S corporation's qualified conservation contribution is not a disallowed qualified conservation contribution under this paragraph (j), then:

(A) The distributive share or pro rata share of any ultimate member holding a direct interest in the contributing partnership or contributing S corporation is not a disallowed qualified conservation contribution; and

(B) Any upper-tier partnership or upper-tier S corporation that receives an allocated portion of such qualified conservation contribution must separately apply the rules of section 170(h)(7) and this paragraph (j) and paragraphs (k) through (m) of this section to determine whether that upper-tier partnership's or upper-tier S corporation's allocated portion is a disallowed qualified conservation contribution.

(iii) *If the Disallowance Rule applies to an upper-tier partnership or an upper-tier S corporation*. If an upper-tier partnership's or upper-tier S corporation's allocated portion is a disallowed qualified conservation contribution under this paragraph (j), then:

(A) Any subsequent upper-tier partnership's or upper-tier S corporation's allocated portion of such allocated portion is a disallowed qualified conservation contribution, regardless of whether the subsequent upper-tier partnership's or upper-tier S corporation's allocated portion exceeds 2.5 times the sum of each of the subsequent upper-tier partnership's or upper-tier S corporation's ultimate member's relevant basis; and

(B) No person holding a direct or indirect interest in that upper-tier partnership or upper-tier S corporation may claim a deduction under any provision of the Code with respect to any amount of that upper-tier partnership's or upper-tier S corporation's allocated portion, regardless of whether that person's distributive share or pro rata share of the allocated portion exceeds 2.5 times its relevant basis. However, this does not affect the application of this paragraph (j) and paragraphs (k) through (m) of this section to another partner of the contributing partnership; for example, if the qualified conservation contribution is not a disallowed qualified conservation contribution with respect to the contributing partnership, then the distributive share of such contribution of an ultimate member holding a direct interest in the contributing partnership is not a disallowed qualified conservation contribution, notwithstanding that the qualified conservation contribution is a disallowed qualified conservation contribution with respect to one or more upper-tier partnerships or upper-tier S corporations.

(iv) *If the Disallowance Rule does not apply to an upper-tier partnership or upper-tier S corporation.* If an upper-tier partnership's or upper-tier S corporation's allocated portion is not a disallowed qualified conservation contribution under this paragraph (j), then:

(A) The distributive share or pro rata share of such allocated portion of any ultimate member holding a direct interest in the upper-tier partnership or upper-tier S corporation is not a disallowed qualified conservation contribution; and

(B) Any subsequent upper-tier partnership or upper-tier S corporation that receives an allocated portion of such allocated portion must separately apply the rules of section 170(h)(7) and this paragraph (j) and paragraphs (k) through (m) of this section to determine whether that subsequent upper-tier partnership's or upper-tier S corporation's allocated portion is treated as a disallowed qualified conservation contribution.

(5) *No inference.* There is no presumption that a qualified conservation contribution that is not a disallowed qualified conservation contribution as defined in paragraph (j)(3)(vii) of this section is compliant with section 170, any other section of the Code, the regulations, or any other guidance. Compliance with section 170(h)(7) and this paragraph (j) and paragraphs (k) through (n) of this section is not a safe harbor for purposes of any other provision of law or with respect to the value of the contribution. Such transactions are subject to adjustment or disallowance for any other reason, including failure to satisfy the other requirements of section 170 or overvaluation of the contribution. In addition, taxpayers who engage in such transactions may be required to disclose under §1.6011–4 the transactions as listed transactions.

(6) *Examples.* The following examples illustrate the rules of this paragraph (j). For these three examples in this paragraph (j)(6), assume that the partnership allocations comply with the rules of subchapter K of chapter 1 of the Code, and that the exceptions in paragraph (n) of this section do not apply.

(i) *Example 1: Disallowed qualified conservation contribution*—(A) *Facts.* A, an individual, and B, a C corporation, form AB Partnership, a partnership for Federal income tax purposes. AB Partnership acquires real property. Two years later, AB Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. AB Partnership allocates the contribution equally to A and B. A's relevant basis is $30X, and B's relevant basis is $8X.

(B) *Analysis.* A and B are the ultimate members of AB Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. The claimed amount of AB Partnership's qualified conservation contribution is $100X, which exceeds 2.5 times the sum of A's and B's relevant bases, which is $95X ($95X = 2.5 × (A's $30X relevant basis + B's $8X relevant basis)). Therefore, AB Partnership's contribution is a disallowed qualified conservation contribution. No person may claim any deduction with respect to this contribution, even though A's $50X distributive share of the contribution does not exceed 2.5 times A's $30X relevant basis.

(ii) *Example 2: Not a disallowed qualified conservation contribution*—(A) *Facts.* Individuals C and D form CD Partnership, a partnership for Federal income tax purposes. CD Partnership acquires real property. Two years later, CD

Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. CD Partnership allocates the contribution $5X to C and $95X to D. C's relevant basis is $6X, and D's relevant basis is $34X.

(B) *Analysis*. C and D are the ultimate members of CD Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. The claimed amount of CD Partnership's qualified conservation contribution is $100X, which does not exceed 2.5 times the sum of C's and D's relevant bases, which is also $100X ($100X = 2.5 × (C's $6X relevant basis + D's $34X relevant basis)). Therefore, CD Partnership's contribution is not a disallowed qualified conservation contribution (that is, not disallowed by section 170(h)(7) and this paragraph (j)) with respect to CD Partnership, C, or D, even though D's $95X distributive share of the contribution exceeds 2.5 times D's $34X relevant basis.

(iii) *Example 3: Tiered partnerships*—(A) *Facts*. Individuals E and F form UTP Partnership, a partnership for Federal income tax purposes. UTP Partnership and G, a C corporation, form LTP Partnership, a partnership for Federal income tax purposes. LTP Partnership acquires real property. Two years later, LTP Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. LTP Partnership allocates the contribution $5X to G and $95X to UTP Partnership. UTP Partnership allocates its $95X portion of the contribution $45X to E and $50X to F. G's relevant basis is $10X, E's relevant basis is $11X, and F's relevant basis is $21X.

(B) *Analysis for LTP Partnership*. The ultimate members of LTP Partnership are G, E, and F because they each receive a distributive share of the qualified conservation contribution and are not a partnership or S corporation. Because UTP Partnership is a partnership, it is not an ultimate member of LTP Partnership, even though it receives a distributive share of the qualified conservation contribution. The amount of LTP Partnership's qualified conservation contribution is $100X, which does not exceed 2.5 times the sum of each of the ultimate member's relevant basis, which is $105X ($105X = 2.5 × (G's $10X relevant basis + E's $11X relevant basis + F's $21X relevant basis)). Therefore, LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and this paragraph (j)) with respect to LTP Partnership and G.

(C) *Analysis for UTP Partnership*. Because UTP Partnership receives an allocated portion, UTP Partnership must apply this paragraph (j) and paragraphs (k) through (m) of this section to determine whether its allocated portion is a disallowed qualified conservation contribution. The ultimate members of UTP Partnership are E and F because they each receive a distributive share of UTP Partnership's allocated portion and are not partnerships or S corporations. The amount of UTP Partnership's allocated portion of LTP Partnership's qualified conservation contribution is $95X, which exceeds 2.5 times the sum of E's and F's relevant bases, which is $80X ($80X = 2.5 × (E's $11X relevant basis + F's $21X relevant basis)). Therefore, UTP Partnership's allocated portion of LTP Partnership's contribution is a disallowed qualified conservation contribution with respect to UTP Partnership, E, and F. No partner of UTP Partnership may claim any deduction with respect to this contribution, even though F's $50X distributive share of the contribution does not exceed 2.5 times F's $21X relevant basis. This does not affect the determination that G's distributive share of the contribution is not a disallowed qualified conservation contribution.

(k) *Determination of relevant basis*. For purposes of this section, the term *relevant basis* means, with respect to any ultimate member, the portion of such ultimate member's modified basis (as determined under paragraph (l) of this section) that is allocable (under the rules of paragraph (m) of this section) to the portion of the real property with respect to which the qualified conservation contribution is made.

(l) *Determination of modified basis*—(1) *In general*. In the case of an ultimate member holding a direct interest in a partnership, the ultimate member's modified basis is determined by such partnership immediately before the qualified conservation contribution is made in the manner described in paragraph (l)(2) of this section. In the case of an ultimate member holding a direct interest in an S corporation, the ultimate member's modified basis is determined by such S corporation in the manner described in paragraph (l)(3) of this section.

(2) *Partners in partnerships*—(i) *Computation.* For purposes of this section, the term *modified basis* means, with respect to any ultimate member that is a direct partner in either a contributing partnership or an upper-tier partnership, such ultimate member's adjusted basis in its interest in the partnership in which the ultimate member holds a direct interest as of the beginning of the first day of the partnership's taxable year in which the qualified conservation contribution is made, with adjustments as determined under paragraphs (l)(2)(ii) through (vi) of this section. However, if the ultimate member was not a partner as of the beginning of the first day of the partnership's taxable year in which the qualified conservation contribution is made, then the term *modified basis* means such ultimate member's adjusted basis in its interest in the partnership immediately after the transaction that resulted in the ultimate member becoming a partner, with adjustments as determined under paragraphs (l)(2)(ii) through (vi) of this section. The adjustments under paragraphs (l)(2)(ii) through (vi) must be made in the order in which they are listed.

(ii) *Step 1.* First, the computation of modified basis must start with the ultimate member's adjusted basis under paragraph (l)(2)(i) of this section and then reflect an increase for any contributions made by the ultimate member to the partnership during the portion of the year commencing with the beginning of the taxable year of the partnership and ending immediately prior to the time of day at which the qualified conservation contribution is made as provided in section 722 of the Code.

(iii) *Step 2.* Second, if between the beginning of the partnership's taxable year and the time of day at which the qualified conservation contribution is made, the ultimate member acquired additional interests in the partnership, the amount determined under paragraph (l)(2)(ii) of this section must be increased by the ultimate member's initial basis in those additional interests. If, between the beginning of the partnership's taxable year and the time of day at which the qualified conservation contribution is made, the ultimate member partially disposed of its interest in the partnership, the amount determined under paragraph (l)(2)(ii) of this section must be decreased by the ultimate member's basis in the interests disposed of.

(iv) *Step 3.* Third, the amount determined under paragraph (l)(2)(iii) of this section must be adjusted, as provided in section 705 of the Code, by the ultimate member's hypothetical distributive share of partnership items attributable to the portion of the year commencing with the beginning of the taxable year of the partnership and ending immediately prior to the time of day at which the qualified conservation contribution is made. In making this determination, the partnership must apply the rules of §1.706–4 and apply a hypothetical interim closing method to allocate the partnership's items attributable to the portion of the year commencing with the beginning of the taxable year of the partnership and ending immediately prior to the time of day at which the qualified conservation contribution is made. The partnership cannot apply any convention in §1.706–4(c) to the hypothetical determination of the partners' distributive shares, but rather must perform the calculation as though the determination occurred immediately prior to the time of day at which the qualified conservation contribution is made. This hypothetical determination of the partners' distributive shares is only for purposes of calculating modified basis. This paragraph (l) does not require the partnership to use the interim closing method with respect to the determination of its partners' actual distributive shares of partnership items of income, gain, loss, deduction, and credit for the taxable year in which the qualified conservation contribution is made or otherwise. *See* § 1.706–4 for applicable rules for the determination of a partner's distributive share when a partner's interest varies during a partnership taxable year.

(v) *Step 4.* Fourth, the amount determined under paragraph (l)(2)(iv) of this section must be reduced (but not below zero) by any distributions made by the partnership to the ultimate member during the portion of the year commencing with the beginning of the taxable year of the partnership and ending immediately prior to the time of day at which the qualified conservation contribution is made as provided in section 733 of the Code.

(vi) *Step 5.* Fifth, the amount determined under paragraph (l)(2)(v) of this section must be reduced by the full amount of the ultimate member's share of § 1.752–1 liabilities of any partnership (including a lower-tier partnership). The remaining amount is such ultimate member's modified basis. Thus, an ultimate member's modified basis may be less than zero.

(3) *S corporation shareholder*—(i) *Computation.* For purposes of this section, the term *modified basis* means, with respect to any ultimate member that is a shareholder of either a contributing S corporation or an upper-tier S corporation, such ultimate member's adjusted basis in its shares in the S corporation as of the end of the S corporation's taxable year in which the qualified conservation contribution is made, with adjustments as determined under paragraphs (l)(3)(ii) and (iii) of this section. However, if the ultimate member was not a shareholder at the end of the S corporation's taxable year in which the qualified conservation contribution is made, then the term *modified basis* means such ultimate member's adjusted basis in its shares in the S corporation immediately prior to the transaction that terminated its interest in the S corporation, with adjustments as determined under paragraphs (l)(3)(ii) and (iii) of this section. Modified basis does not include the ultimate member's adjusted basis in any indebtedness of the S corporation to the ultimate member. The adjustments under paragraphs (l)(3)(ii) and (iii) of this section must be made in the order in which they are listed.

(ii) *Step 1.* First, the computation of modified basis must start with the ultimate member's adjusted basis under paragraph (l)(3)(i) of this section, and then reflect an increase for the extent to which the ultimate member's adjusted basis reflects a reduction as a result of the qualified conservation contribution. Thus, the ultimate member's modified basis with respect to a qualified conservation contribution does not reflect any reduction for the ultimate member's pro rata share of the S corporation's basis in the conservation easement or other property contributed in the qualified conservation contribution.

(iii) *Step 2.* Second, the amount determined under paragraph (l)(3)(ii) of this section must be multiplied by the number of days during the S corporation's taxable year in which the ultimate member was a shareholder and divided by the total number of days during the S corporation's taxable year. The resulting amount is such ultimate member's modified basis.

(4) *Examples.* The following examples illustrate the provisions of this paragraph (l). For the four examples in this paragraph (l)(4), assume that the partnership allocations comply with the rules of subchapter K of chapter 1 of the Code and the exceptions in paragraph (n) of this section do not apply.

(i) *Example 1*—(A) *Facts.* AB Partnership is a calendar-year partnership for Federal income tax purposes whose partners are A and B, each of whom is an individual and has a 50 percent interest in income, gain, loss, and deduction. Several years ago, B contributed property to AB Partnership subject to a § 1.752–1 liability. At the beginning of AB Partnership's 2024 taxable year (the beginning of the day on January 1, 2024), A's adjusted basis in its interest in AB Partnership is $19X, and B's adjusted basis in its interest in AB Partnership is $17X. At 10:01 a.m. on August 29, 2024, AB Partnership makes a qualified conservation contribution. On August 29, 2024, the amount of the § 1.752–1 liability is $10X and is allocated under the rules of section 752 to A. During 2024, there were no variations in any partner's interests in AB Partnership within the meaning of section 706. During 2024, AB Partnership earned $8X of ordinary income and sustained ($4X) of capital loss in the ordinary course of its business, both of which are allocated equally to A and B. Within 2024, AB Partnership earned $6X of ordinary income, and sustained ($4X) of capital loss between the beginning of the day on January 1, 2024, and 10:00 a.m. on August 29, 2024, and AB Partnership earned $2X of ordinary income, and sustained $0X of capital loss between 10:01 a.m. on August 29, 2024, and the end of the day on December 31, 2024. Other than the qualified conservation contribution, none of AB Partnership's items are extraordinary items within the meaning of §1.706–4(e)(2). In April 2024, AB Partnership distributed $1X cash to A. In November 2024, B contributed $2X cash to AB Partnership.

(B) *Analysis*. The ultimate members of AB Partnership are A and B because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. To determine A's and B's modified bases, AB Partnership must start with A's and B's adjusted bases in AB Partnership as of the beginning of the first day of the taxable year of AB Partnership and then make the adjustments required under paragraphs (l)(2)(ii) through (vi) of this section. Accordingly, the computation of A's beginning modified basis begins with $19X, and the computation of B's modified basis begins with $17X. First, those amounts must be increased by any contributions between the beginning of the day on January 1, 2024, and 10 a.m. on August 29, 2024. Because there were none, after this step, the computation of A's modified basis remains at $19X and the computation of B's modified basis remains at $17X. Next, these amounts must be adjusted for any additional acquisitions of partnership interests by an existing partner or partial dispositions of partnership interests by a continuing partner between the beginning of the partnership's taxable year and the time of day at which the qualified conservation contribution is made. Because there were none, after this step, the computation of A's modified basis remains at $19X and the computation of B's modified basis remains at $17X. Then these amounts must be adjusted as provided in section 705 by A's and B's hypothetical distributive shares of AB Partnership's items attributable to the portion of the year between the beginning of the day on January 1, 2024, and 10:00 a.m. on August 29, 2024. Thus, the computations of A's and B's modified bases will each reflect an increase for their hypothetical $3X distributive share of the $6X ordinary income that AB Partnership earned between the beginning of the day on January 1, 2024, and 10:00 a.m. on August 29, 2024, and a decrease for their hypothetical ($2X) distributive share of the ($4X) capital loss that AB Partnership incurred between the beginning of the day on January 1, 2024, and 10:00 a.m. on August 29, 2024. Therefore, after this step, the computation of A's modified basis reflects an increase from $19X to $20X, and the computation of B's modified basis reflects an increase from $17X to $18X. Next, these amounts must be reduced by any distributions between the beginning of the day on January 1, 2024, and 10:00 a.m. on August 29, 2024. Thus, the computation of A's modified basis reflects a reduction from $20X to $19X. B did not receive any distribution, so the computation of B's modified basis remains at $18X. Finally, the full amount of A's and B's shares of §1.752–1 liabilities must be subtracted. Thus, the computation of A's modified basis reflects a reduction from $19X to $9X, which is A's modified basis. B's modified basis is $18X.

(ii) *Example 2*—(A) *Facts*. CD Partnership, a partnership for Federal income tax purposes, is a calendar-year partnership using the calendar day convention under §1.706–4 whose partners on January 1, 2024, are C and D, each of whom is an individual and has a 50 percent interest in income, gain, loss, and deduction. On March 15, 2024, C sells its interest to E, a C corporation. At 1:15 p.m. on September 15, 2024, CD Partnership makes a qualified conservation contribution. On September 21, 2024, D sells its interest to F, an individual. During 2024, CD Partnership earned $8X of ordinary income and sustained ($14X) of ordinary loss. Within 2024, CD Partnership earned all $8X of ordinary income in November and December, and sustained all ($14X) of ordinary loss in April through August. In May 2024, D contributed $6X cash to CD Partnership, and E contributed property with a fair market value of $6X and basis of $3X. D and E are equal partners during the period in which they are both partners. CD Partnership made no distributions during 2024. CD Partnership had no §1.752–1 liabilities during 2024. In accordance with §1.706–4(e)(2)(xiii), CD Partnership treats its qualified conservation contribution as an extraordinary item allocable only to D and E, its partners at 1:15 p.m. on September 15, 2024. Other than the qualified conservation contribution, none of AB Partnership's items are extraordinary items within the meaning of §1.706–4(e)(2). CD Partnership uses the proration method under §1.706–4 to allocate its items among C, D, E, and F. Under the proration method, CD Partnership allocates each C, D, E, and F a distributive share of a portion of both the $8X ordinary income and the ($14X) ordinary loss. D's adjusted basis in its interest in CD Partnership at the beginning of CD Partnership's 2024 taxable year (the beginning of the day on January 1, 2024) is $8X. E's adjusted basis in its interest in CD Partnership immediately after E acquires C's interest in CD Partnership is $6X.

(B) *Analysis*. The ultimate members of CD Partnership are D and E because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. To determine D's and E's modified bases, CD Partnership must start with D's and E's adjusted bases in CD Partnership as of the beginning of the day on January 1, 2024, and then make the adjustments required under paragraphs (l)(2)(ii) through (vi) of this section. However, because E was not a partner as of the beginning of the day on January 1, 2024, CD Partnership must start with E's adjusted basis immediately after E's purchase of C's interest in CD Partnership. Accordingly, the computation of D's modified basis begins with $8X, and the computation of E's modified basis begins with $6X. Then, these amounts must be increased by any contributions made by D or E, respectively, to CD Partnership between the beginning of the day on January 1, 2024, and 1:14 p.m. on September 15, 2024. Therefore, the computation of D's modified basis reflects an increase from $8X to $14X (for D's $6X contribution of cash to CD Partnership in May 2024), and the computation of E's modified basis reflects an increase from $6X to $9X (for E's contribution of property to CD Partnership with a basis of $3X in May 2024). Next, these amounts must be adjusted for any additional acquisitions of partnership interests by an existing partner or partial dispositions of partnership interests by a continuing partner between the beginning of the partnership's taxable year and the time of day at which the qualified conservation contribution is made. Because there were none, after this step, the computation of D's modified basis remains at $14X and the computation of E's modified basis remains at $9X. Next, these amounts must be adjusted as provided in section 705 by D's and E's hypothetical distributive shares of CD Partnership's items attributable to the portion of the year between the beginning of the day on January 1, 2024, and 1:14 p.m. on September 15, 2024. CD Partnership must perform the analysis using an interim closing method to a hypothetical variation at 1:14 p.m. on September 15, 2024, immediately prior to the qualified conservation contribution. The computation of D's modified basis will reflect an adjustment for its hypothetical distributive share of all CD Partnership's items incurred from the beginning of the day on January 1, 2024, through 1:14 p.m. on September 15, 2024. The computation of E's modified basis will reflect an adjustment for its hypothetical distributive share of all CD Partnership's items incurred from the end of the day on March 15, 2024, through 1:14 p.m. on September 15, 2024. For purposes of this paragraph (l)(4)(ii)(B) (*Example 2*), it does not matter that CD Partnership actually used the proration method to allocate its 2024 income. Instead, under this hypothetical calculation of the distributive shares, the computation of D's and E's modified bases will each reflect a reduction for their 50 percent share of the ($14X) ordinary loss. Because none of CD Partnership's $8X of ordinary income was earned between the beginning of the day on January 1, 2024, and 1:14 p.m. on September 15, 2024, neither D's nor E's modified basis will reflect an increase for any amount of that income. Thus, after this step, the computation of D's modified basis reflects a reduction from $14X to $7X, and the computation of E's modified basis reflects a reduction from $9X to $2X. Then, these amounts must be reduced by any distributions between the beginning of the day on January 1, 2024, and 1:14 p.m. on September 15, 2024. Because there were none, after this step, the computation of D's modified basis remains at $7X, and the computation of E's modified basis remains at $2X. Finally, the full amount of D's and E's shares of §1.752–1 liabilities must be subtracted. Because there were none, D's modified basis is $7X, and E's modified basis is $2X.

(iii) *Example 3*—(A) *Facts*. HI Inc. is a calendar-year S corporation whose shareholders on January 1, 2024, are H and I, each of whom owns 50 percent of the shares. On May 1, 2024, H sells all of its stock to J. In June 2024, HI Inc. contributes a conservation easement that is a qualified conservation contribution on 400 acres of real property. HI Inc.'s adjusted basis in the conservation easement is $12X (which is different from HI Inc.'s adjusted basis in the 400 acres and also may be different from the value of the conservation easement). On July 1, 2024, I sells all of its stock to K. Under §1.1377–1, HI Inc. allocates its qualified conservation contribution ⅙ to H, ¼ to I, ⅓ to J, and ¼ to K. Pursuant to the second sentence of section 1367(a)(2)(B), as a result of the qualified conservation contribution, H's adjusted basis in its shares is reduced by $2X, I's adjusted basis in its shares is reduced by $3X, J's adjusted basis in its shares is reduced by $4X, and K's adjusted basis in its shares is reduced by $3X. At the end of HI Inc.'s 2024 taxable year (the end of the day on December 31, 2024), J's adjusted basis in its shares is $15X and K's adjusted basis in its shares is $11X. Immediately prior to H's sale to J, H's adjusted basis in its shares was $8X. Immediately prior to I's sale to K, I's adjusted basis in its shares was $7X. Whether H, I, J, or K have adjusted basis in indebtedness of HI Inc., has no effect on the computation of their modified bases. H is an estate of a deceased shareholder, and I, J, and K are individuals that are not nonresident aliens.

(B) *Analysis*. The ultimate members of HI Inc. are H, I, J, and K, because they each receive a pro rata share of the qualified conservation contribution and are not partnerships or S corporations. To determine H's, I's, J's, and K's modified bases, HI Inc. must begin with each shareholder's adjusted basis in its shares as of the end of the day on December 31, 2024 (the end of the S corporation's taxable year in which it made the qualified conservation contribution). However, because H and I were not shareholders as of the end of the day on December 31, 2024, HI Inc. must begin with H's adjusted basis immediately before H's sale to J, and I's adjusted basis immediately before I's sale to K. Accordingly, the computation of H's modified basis begins with $8X, the computation of I's modified basis begins with $7X, the computation of J's modified basis begins with $15X, and the computation of K's modified basis begins with $11X. Next, HI Inc. must increase these amounts by the extent the adjusted bases were reduced as a result of the qualified conservation contribution. Accordingly, the computation of H's modified basis reflects an increase from $8X to $10X, the computation of I's modified basis reflects an increase from $7X to $10X, the computation of J's modified basis reflects an increase from $15X to $19X, and the computation of K's modified basis reflects an increase from $11X to $14X. Finally, HI Inc. must multiply each of these amounts by the number of days during 2024 in which each ultimate member was a shareholder, and divide by 366 (the total number of days in HI Inc.'s 2024 taxable year). H was a shareholder for 122 days. Thus, H's modified basis is $3.33X ($10X × 122/366). I was a shareholder for 183 days. Thus, I's modified basis is $5X ($10X × 183/366). J was a shareholder for 244 days. Thus, J's modified basis is $12.67X ($19X × 244/366). K was a shareholder for 183 days. Thus, K's modified basis is $7X ($14X × 183/366).

(iv) *Example 4*—(A) *Facts*. PQ Partnership is a calendar-year partnership for Federal income tax purposes whose partners are individuals P and Q. At the beginning of PQ Partnership's 2024 taxable year (the beginning of the day on January 1, 2024), P has a sixty percent interest in all of PQ Partnership's items, including items of income, gain, loss, deduction, credit, and charitable contributions, and P's adjusted basis in its interest in PQ Partnership is $60X. At the beginning of PQ Partnership's 2024 taxable year, Q has a forty percent interest in all of PQ Partnership's items, including items of income, gain, loss, deduction, credit, and charitable contributions, and Q's adjusted basis in its interest in PQ Partnership is $30X. On March 15, 2024, P sells two-thirds of P's interest in PQ Partnership to individual Z, who was not previously a partner in PQ Partnership, for $55X. At the time of the sale, P's adjusted basis in the partnership interests P sold to Z was $40X. At noon on August 29, 2024, PQ Partnership makes a qualified conservation contribution. PQ Partnership allocates twenty percent of the qualified conservation contribution to P, forty percent to Q, and forty percent to Z. Between January 1 and August 29, 2024, PQ Partnership had no items of income, gain, loss, or deduction, and did not make any distributions. No partner made any contributions during 2024. PQ Partnership did not have any §1.752–1 liabilities during 2024.

(B) *Analysis*. P, Q, and Z are the ultimate members of PQ Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. To determine P's, Q's, and Z's modified bases, PQ Partnership must start with P's, Q's, and Z's adjusted bases in PQ Partnership as of the beginning of the first day of the taxable year of PQ Partnership and then make the adjustments required under paragraphs (l)(2)(ii) through (vi) of this section. However, because Z was not a partner as of the beginning of the day on January 1, 2024, PQ Partnership must start with Z's adjusted basis immediately after Z's purchase of two-thirds of P's interest in PQ Partnership. Accordingly, the computation of P's modified basis begins with $60X, the computation of Q's modified basis begins with $30X, and the computation of Z's modified basis begins with $55X. First, those amounts must be increased by any contributions between the beginning of the day on January 1, 2024, and noon on August 29, 2024. Because there were none, after this step, the computation of P's modified basis remains at $60X, the computation of Q's modified basis remains at $30X, and the computation of Z's modified basis remains at $55X. Next, these amounts must be adjusted for any additional acquisitions of partnership interests by an existing partner or partial dispositions of partnership interests by a continuing partner between the beginning of the partnership's taxable year and the time of day at which the qualified conservation contribution is made. P sold two-thirds of its interest to Z prior to PQ Partnership's qualified conservation contribution; P's basis in the interests it sold was $40X. As a result, the computation of P's modified basis reflects a reduction from $60X to $20X. Then these amounts must be adjusted as provided in section 705 by P's, Q's, and Z's hypothetical distributive shares of PQ Partnership's items attributable to the portion of the year between the beginning of the day on January 1, 2024, and noon on August 29, 2024. Because there were none, after this step, the computation of P's modified basis remains at $20X, the computation of Q's modified basis remains at $30X, and the computation of Z's modified basis remains at $55X. Next, these amounts must be reduced by any distributions between the beginning of the day on January 1, 2024, and noon on August 29, 2024. Because there were none, after this step, the computation of P's modified basis remains at $20X, the computation of Q's modified basis remains at $30X, and the computation of Z's modified basis remains at $55X. Finally, the full amount of P's, Q's, and Z's shares of §1.752–1 liabilities must be subtracted. Because there were none, P's modified basis is $20X, Q's modified basis is $30X, and Z's modified basis is $55X.

(m) *Allocation of modified basis*—(1) *In general*. An allocation of an ultimate member's modified basis to the portion of the real property with respect to which the qualified conservation contribution is made must be made in accordance with this paragraph (m). Rules for allocating an ultimate member's modified basis in a contributing partnership are provided in paragraph (m)(2) of this section. Rules for allocating an ultimate member's modified basis in a contributing S corporation are provided in paragraph (m)(3) of this section. Rules for allocating an ultimate member's modified basis in an upper-tier partnership are provided in paragraph (m)(4) of this section. Rules for allocating an ultimate member's modified basis in an upper-tier S corporation are provided in paragraph (m)(5) of this section. Records must be kept in accordance with paragraph (m)(6) of this section.

(2) *Determination of relevant basis for an ultimate member holding a direct interest in a contributing partnership*—(i) *Narrative rule*. This paragraph (m)(2) applies in the case of an ultimate member holding a direct interest in a contributing partnership and provides that a contributing partnership must determine each such ultimate member's relevant basis as provided in this paragraph (m)(2). Relevant basis equals each ultimate member's modified basis as determined under paragraph (l)(2) of this section multiplied by a fraction—

(A) The numerator of which is the ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made as determined under paragraph (m)(2)(ii) of this section; and

(B) The denominator of which is the ultimate member's portion of the adjusted basis in all the contributing partnership's properties as determined under paragraph (m)(2)(iii) of this section.

(ii) *Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made*. For purposes of this paragraph (m)(2), an ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made equals the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made (determined as of the time of day of the contribution) multiplied by a fraction—

(A) The numerator of which is the ultimate member's distributive share of the qualified conservation contribution; and

(B) The denominator of which is the total amount of the contributing partnership's qualified conservation contribution.

(iii) *Ultimate member's portion of the adjusted basis in all the contributing partnership's properties*—(A) For purposes of this paragraph (m)(2), an ultimate member's portion of the adjusted basis in all the contributing partnership's properties is equal to the sum of:

(*1*) The ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made as determined under paragraph (m)(2)(ii) of this section; plus

(*2*) The ultimate member's portion of the adjusted basis in all the contributing partnership's properties other than the portion of the real property with respect to which the qualified conservation contribution is made as determined under paragraph (m)(2)(iii)(B) of this section.

(B) To determine a partner's portion of the adjusted basis in all of a contributing partnership's properties, the contributing partnership must apportion among its partners its adjusted basis in each of its properties (except the portion of the real property with respect to which the qualified conservation contribution is made), using the adjusted basis immediately before the qualified conservation contribution, without duplication or omission of any property, and by treating the adjusted basis in each property as not less than zero. This apportionment must be done under principles similar to the determination of the partners' interests in the partnership under section 704(b), including the factors in §1.704–1(b)(3)(ii). In addition, the apportionment must reflect section 704(c) principles. For example, if a partnership property has built-in loss (the adjusted basis of the property exceeds its fair market value), and section 704(c) would require all of that built-in loss to be allocated to a certain partner if that property was sold, all of the basis in the property that exceeds the property's fair market value must be apportioned to the partner to whom the loss would be allocated if the property was sold.

(iv) *Formulaic rule.* The rule of this paragraph (m)(2) is also expressed in the following formula:

Equation 1 to Paragraph (m)(2)(iv)

$$R = M \times (T \div (D + T))$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

D = Ultimate member's portion of the adjusted basis in all the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

T = Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (B \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

B = Ultimate member's distributive share of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(3) *Determination of relevant basis for an ultimate member holding a direct interest in a contributing S corporation*—(i) *Narrative rule.* This paragraph (m)(3) applies in the case of an ultimate member holding a direct interest in a contributing S corporation and provides that a contributing S corporation must determine each such ultimate member's relevant basis as provided in this paragraph (m)(3). Relevant basis equals each ultimate member's modified basis as determined under paragraph (l)(3) of this section multiplied by a fraction—

(A) The numerator of which is the ultimate member's pro rata portion of the contributing S corporation's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made; and

(B) The denominator of which is the ultimate member's pro rata portion of the adjusted basis in all the contributing S corporation's properties (including the portion of the real property with respect to which the qualified conservation contribution is made).

(ii) *Formulaic rule.* The rule of this paragraph (m)(3) is also expressed in the following formula:

Equation 2 to Paragraph (m)(3)(ii)

$$R = M \times (E \div F)$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

E = Ultimate member's pro rata portion of the contributing S corporation's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

F = Ultimate member's pro rata portion of the adjusted basis in all the contributing S corporation's properties (including the portion of the real property with respect to which the qualified conservation contribution is made).

(4) *Determination of relevant basis for an ultimate member holding a direct interest in an upper-tier partnership*—(i) *In general.* This paragraph (m)(4) applies in the case of an ultimate member holding a direct interest in an upper-tier partnership. Each such ultimate member's modified basis must be traced through all upper-tier partnerships to the contributing partnership, and the contributing partnership must determine the relevant basis. This involves a multi-step process under which, beginning with the upper-tier partnership in which the ultimate member holds a direct interest, each upper-tier partnership must perform calculations, and then finally the contributing partnership must use those calculations to compute the ultimate member's relevant basis. For simplicity, this paragraph (m)(4) describes a situation in which there are two tiers of partnerships—a contributing partnership and an upper-tier partnership. In a situation involving more tiers, each partnership must apply the rules and principles of this paragraph (m)(4) iteratively to determine relevant basis.

(ii) *Upper-tier partnership*—(A) *Narrative rule*—(*1*) *In general*. The upper-tier partnership must determine the portion of each ultimate member's modified basis that is allocable to the upper-tier partnership's interest in the partnership in which it holds a direct interest (in a situation involving only two tiers of partnerships, that will be the contributing partnership). This determination must be done in accordance with the principles of paragraph (m)(2) of this section, the rule in paragraph (m)(4)(ii)(A)(*2*) of this section, and the formula provided in paragraph (m)(4)(ii)(B) of this section. In other words, the formula provided in paragraph (m)(4)(ii)(B) of this section is similar to the formula provided in paragraph (m)(2)(iv) of this section, except that, instead of determining the portion of modified basis that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made, the formula in paragraph (m)(4)(ii)(B) of this section determines the portion of modified basis that is allocable to the upper-tier partnership's interest in the next lower-tier partnership. As explained in paragraph (m)(4)(iii) of this section, the contributing partnership will then use the amount determined under the formula in paragraph (m)(4)(ii)(B) of this section to compute the portion of modified basis that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made.

(*2*) *Apportionment of upper-tier partnership's adjusted bases in its properties*. To determine a partner's portion of the adjusted basis in all of an upper-tier partnership's properties, the upper-tier partnership must apportion among its partners its adjusted basis in each of its properties (except its interest in the lower-tier partnership), using the adjusted basis immediately before the qualified conservation contribution, without duplication or omission of any property, and by treating the adjusted basis in each property as not less than zero. This apportionment must be done under principles similar to the determination of the partners' interests in the partnership under section 704(b), including the factors in §1.704–1(b)(3)(ii). In addition, the apportionment must reflect section 704(c) principles. For example, if a partnership property has built-in loss (the adjusted basis of the property exceeds its fair market value), and section 704(c) would require all of that built-in loss to be allocated to a certain partner if that property was sold, all of the basis in the property that exceeds the property's fair market value must be apportioned to the partner to whom the loss would be allocated if the property was sold.

(B) *Formulaic rule*. The rule of this paragraph (m)(4)(ii) is also expressed in the following formula:

Equation 3 to Paragraph (m)(4)(ii)(B)

$$G = M \times (U \div (J + U))$$

Where:

G = The portion of the ultimate member's modified basis that is allocable to the upper-tier partnership's interest in the contributing partnership.

M = Modified basis as determined under paragraph (l) of this section.

J = Ultimate member's portion of the adjusted basis in all the upper-tier partnership's properties (other than the upper-tier partnership's interest in the contributing partnership) as determined under paragraph (m)(4)(ii)(A)(*2*) of this section.

U = Ultimate member's share of the upper-tier partnership's adjusted basis in its interest in the contributing partnership, determined according to the following formula: $H \times (B \div K)$.

H = Upper-tier partnership's adjusted basis in its interest in the contributing partnership.

B = Ultimate member's distributive share of the qualified conservation contribution.

K = Upper-tier partnership's allocated portion of the qualified conservation contribution.

(iii) *Contributing partnership*—(A) *Narrative rule*. After completion of the computations under paragraph (m)(4)(ii) of this section, the contributing partnership must determine the portion of the amount determined under item G (*see* paragraph (m)(4)(ii)(B) of this section) with respect to each ultimate member that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made. This determination must be done in accordance with the principles of paragraph (m)(2) of this section and the formula provided in paragraph (m)(4)(iii)(B) of this section.

(B) *Formulaic rule.* The rule of this paragraph (m)(4)(iii) is also expressed in the following formula:

Equation 4 to Paragraph (m)(4)(iii)(B)

$$R = G \times (V \div (L + V))$$

Where:

R = Relevant basis.

G = Amount determined with respect to item G as described under paragraph (m)(4)(ii)(B) of this section.

L = Upper-tier partnership's portion of adjusted basis in all the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

V = Upper-tier partnership's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (K \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

K = Upper-tier partnership's allocated portion of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(5) *Determination of relevant basis for an ultimate member holding a direct interest in an upper-tier S corporation*—(i) *In general.* This paragraph (m)(5) applies in the case of an ultimate member holding a direct interest in an upper-tier S corporation. Each such ultimate member's modified basis must be traced through the upper-tier S corporation and any upper-tier partnerships to the contributing partnership, and the contributing partnership must determine the relevant basis. This involves a multi-step process under which, beginning with the upper-tier S corporation, the upper-tier S corporation and any upper-tier partnerships must perform calculations, and then finally the contributing partnership must use those calculations to compute the ultimate member's relevant basis. For simplicity, this paragraph (m)(5) describes a situation in which there are two tiers—a contributing partnership and an upper-tier S corporation. In a situation involving more tiers, each partnership and the upper-tier S corporation must apply the rules and principles of this paragraph (m) iteratively to determine relevant basis.

(ii) *Upper-tier S corporation*—(A) *Narrative rule.* The upper-tier S corporation must determine the portion of each ultimate member's modified basis that is allocable to the upper-tier S corporation's interest in the partnership in which it holds a direct interest (in a situation involving only two tiers, that will be the contributing partnership). This determination must be done in accordance with the principles of paragraph (m)(3) of this section and the formula provided in paragraph (m)(5)(ii)(B) of this section. In other words, the formula provided in paragraph (m)(5)(ii)(B) of this section is similar to the formula provided in paragraph (m)(3)(ii) of this section, except that, instead of determining the portion of modified basis that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made, the formula in paragraph (m)(5)(ii)(B) of this section determines the portion of modified basis that is allocable to the upper-tier S corporation's interest in the next lower-tier partnership. As explained in paragraph (m)(5)(iii) of this section, the contributing partnership will then use the amount determined under the formula in paragraph (m)(5)(ii)(B) of this section to compute the portion of modified basis that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made.

(B) *Formulaic rule.* The rule of this paragraph (m)(5)(ii) is also expressed in the following formula:

Equation 5 to Paragraph (m)(5)(ii)(B)

$$N = M \times (P \div Q)$$

Where:

N = Portion of the ultimate member's modified basis that is allocable to the upper-tier S corporation's interest in the contributing partnership.

M = Modified basis as determined under paragraph (l) of this section.

P = Ultimate member's pro rata portion of the upper-tier S corporation's adjusted basis in its interest in the contributing partnership.

Q = Ultimate member's pro rata portion of the adjusted basis in all the upper-tier S corporation's properties (including the upper-tier S corporation's interest in the contributing partnership).

(iii) *Contributing partnership*—(A) *Narrative rule.* After completion of the computations under paragraph (m)(5)(ii) of this section, the contributing partnership must determine the portion of the amount determined under item N (*see* paragraph (m)(5)(ii)(B) of this section) with respect to each ultimate member that is allocable to the portion of the real property with respect to which the qualified conservation contribution is made. This determination must be done in accordance with the principles of paragraph (m)(2) of this section and the formula provided in paragraph (m)(5)(iii)(B) of this section.

(B) *Formulaic rule.* The rule of this paragraph (m)(5)(iii) is also expressed in the following formula:

Equation 6 to Paragraph (m)(5)(iii)(B)

$$R = N \times (W \div (S + W))$$

Where:

R = Relevant basis.

N = Amount determined with respect to item N as described under paragraph (m)(5)(ii)(B) of this section.

S = Upper-tier S corporation's portion of the adjusted basis in all the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

W = Upper-tier S corporation's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (Y \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

Y = Upper-tier S corporation's allocated portion of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(6) *Recordkeeping requirements.* Contributing partnerships, contributing S corporations, upper-tier partnerships, and upper-tier S corporations must maintain dated, written statements in their books and records, by the due date, including extensions, of their Federal income tax returns, substantiating the computation of each ultimate member's adjusted basis, modified basis, and relevant basis. *See* § 1.6001–1. These statements need not be maintained (nor does modified basis or relevant basis need to be computed) with respect to contributions that meet an exception in paragraph (n)(2) or (3) of this section, unless the contribution also meets the exception in paragraph (n)(4) of this section (in which case these statements need to be maintained and modified basis and relevant basis need to be computed).

(7) *Examples.* The following examples illustrate the provisions of this paragraph (m). For the examples in this paragraph (m)(7), assume that the partnership allocations comply with the rules of subchapter K of chapter 1 of the Code and the exceptions in paragraph (n) of this section do not apply.

(i) *Example 1*—(A) *Facts.* YZ Partnership is a partnership for Federal income tax purposes whose partners are individuals Y and Z. YZ Partnership owns 100 acres of real property with an adjusted basis of $10X. YZ Partnership makes a qualified conservation contribution on 60 acres of the property. YZ Partnership claims a contribution of $18X, which it allocates $12X to Y and $6X to Z. YZ Partnership's adjusted basis in the 60 acres is $6X, and its adjusted basis in all of its other properties (including its $4X basis in the 40 acres on which a qualified conservation contribution was not made) is $18X. Y's modified basis is $8X. Y's portion of YZ Partnership's adjusted basis in all partnership property (other than the 60 acres) as determined under paragraph (m)(2)(iii)(B) of this section is $4X. Z's modified basis is $12X. Z's portion of YZ Partnership's adjusted basis in all partnership property (other than the 60 acres) as determined under paragraph (m)(2)(iii)(B) of this section is $14X.

(B) *General analysis.* Y and Z are the ultimate members of YZ Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. Their relevant bases must be determined according to the following formula:

Equation 7 to Paragraph (m)(7)(i)(B)

$$R = M \times (T \div (D + T))$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

D = Ultimate member's portion of the adjusted basis in all of the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

T = Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (B \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

B = Ultimate member's distributive share of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(C) *Y's relevant basis.* With respect to Y:

(*1*) M = $8X.

(*2*) D = $4X.

(*3*) A = $6X.

(*4*) B = $12X.

(*5*) C = $18X.

(*6*) Thus, T is $4X = $6X × ($12X ÷ $18X).

(*7*) Accordingly, Y's relevant basis is $4X = $8X × ($4X ÷ ($4X + $4X)).

(D) *Z's relevant basis.* With respect to Z:

(*1*) M = $12X.

(*2*) D = $14X.

(*3*) A = $6X.

(*4*) B = $6X.

(*5*) C = $18X.

(*6*) Thus, T is $2X = $6X × ($6X ÷ $18X).

(*7*) Accordingly, Z's relevant basis is $1.5X = $12X × ($2X ÷ ($14X + $2X)).

(E) *Sum of the relevant bases.* The amount of YZ Partnership's claimed contribution is $18X, which exceeds 2.5 times the sum of Y's and Z's relevant bases, which is $13.75X ($13.75X = 2.5 × (Y's relevant basis of $4X + Z's relevant basis of $1.5X)). Accordingly, YZ Partnership's contribution is a disallowed qualified conservation contribution. No person may claim any deduction with respect to this contribution.

(ii) *Example 2*—(A) *Facts.* CD Inc. is an S corporation with shareholders C and D, each of whom is an individual that is not a nonresident alien. C owns one third of the outstanding stock in CD Inc., and D owns the remaining two thirds. CD Inc. owns 100 acres of real property with an adjusted basis of $10X. CD Inc. makes a qualified conservation contribution on 60 acres of the property. CD Inc. claims a contribution of $9X, which it allocates $3X to C and $6X to D. CD Inc.'s adjusted basis in the 60 acres is $6X, and its adjusted basis in all its properties (including its $6X basis in the 60 acres) is $24X. C's modified basis in CD Inc. is $8X. D's modified basis in CD Inc. is $12X.

(B) *General analysis.* C and D are the ultimate members of CD Inc. because they each receive a pro rata share of the qualified conservation contribution and are not partnerships or S corporations. Their relevant bases must be determined according to the following formula:

Equation 8 to Paragraph (m)(7)(ii)(B)

$$R = M \times (E \div F)$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

E = Ultimate member's pro rata portion of the contributing S corporation's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

F = Ultimate member's pro rata portion of the adjusted basis in all the contributing S corporation's properties (including the portion of the real property with respect to which the qualified conservation contribution is made).

(C) *C's relevant basis.* With respect to C:

(*1*) M = $8X.

(*2*) E = $2X (⅓ of $6X).

(*3*) F = $8X (⅓ of $24X).

(*4*) Thus, C's relevant basis is $2X = $8X × ($2X ÷ $8X).

(D) *D's relevant basis.* With respect to D:

(*1*) M = $12X.

(*2*) E = $4X (⅔ of $6X).

(*3*) F = $16X (⅔ of $24X).

(*4*) Thus, D's relevant basis is $3X = $12X × ($4X ÷ $16X).

(E) *Sum of the relevant bases.* The amount of CD Inc.'s claimed qualified conservation contribution is $9X, which does not exceed 2.5 times the sum of C's and D's relevant bases, which is $12.50X ($12.50X = 2.5 × (C's relevant basis of $2X + D's relevant basis of $3X)). Accordingly, CD Inc.'s contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and paragraph (j) of this section).

(iii) *Example 3*—(A) *Facts*. LTP Partnership is a partnership for Federal income tax purposes whose partners are individual E and UTP Partnership, a partnership for Federal income tax purposes. UTP Partnership's partners are C corporations P and Q. LTP Partnership owns 300 acres of real property. LTP Partnership makes a qualified conservation contribution on all 300 acres. LTP Partnership claims a qualified conservation contribution of $22X, which it allocates $2X to E and $20X to UTP Partnership. UTP Partnership allocates its $20X share of the qualified conservation contribution $6X to P and $14X to Q. LTP Partnership's basis in the 300 acres is $18X, and its adjusted basis in all of its other properties is $12X. E's modified basis in LTP Partnership is $4X. E's portion of LTP Partnership's adjusted basis in all partnership property (other than the 300 acres) as determined under paragraph (m)(2)(iii)(B) of this section is $4.36X. UTP Partnership's portion of LTP Partnership's adjusted basis in all partnership property (other than the 300 acres) as determined under paragraph (m)(2)(iii)(B) of this section is $7.64X. UTP Partnership's adjusted basis in its interest in LTP Partnership is $19X, and its adjusted basis in all other properties is $6X. P's modified basis in UTP Partnership is $12X. P's portion of UTP Partnership's adjusted basis in all partnership property (other than the interest in LTP Partnership) as determined under paragraph (m)(4)(ii)(A)(*2*) of this section is $3.6X. Q's modified basis in UTP Partnership is $8X. Q's portion of UTP Partnership's adjusted basis of all partnership property (other than the interest in LTP Partnership) as determined under paragraph (m)(4)(ii)(A)(*2*) of this section is $2.4X.

(B) *Analysis: partner E*. (*1*) The ultimate members of LTP Partnership are E, P, and Q because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. Because E holds a direct interest in LTP Partnership, E's relevant basis must be determined in accordance with the following formula:

Equation 9 to Paragraph (m)(7)(iii)(B)(1)

$$R = M \times (T \div (D + T))$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

D = Ultimate member's portion of the adjusted basis in all the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

T = Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (B \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

B = Ultimate member's distributive share of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(*2*) With respect to E:

(*i*) M = $4X.

(*ii*) D = $4.36X.

(*iii*) A = $18X.

(*iv*) B = $2X.

(*v*) C = $22X.

(*vi*) Thus, T is $1.64X = $18X × ($2X ÷ $22X).

(*vii*) Accordingly, E's relevant basis is $1.09X = $4X × ($1.64X ÷ ($4.36X + $1.64X)).

(C) *Analysis: General rule for UTP Partnership*. Because P and Q hold interests in an upper-tier partnership, UTP Partnership must first determine the portions of P's and Q's modified bases that are allocable to UTP Partnership's interest in LTP Partnership. This is to be done according to the following formula:

Equation 10 to Paragraph (m)(7)(iii)(C)

$$G = M \times (U \div (J + U))$$

Where:

G = The portion of the ultimate member's modified basis that is allocable to the upper-tier partnership's interest in the contributing partnership.

M = Modified basis as determined under paragraph (l) of this section.
J = Ultimate member's portion of adjusted basis in all the upper-tier partnership's properties (other than the upper-tier partnership's interest in the contributing partnership) as determined under paragraph (m)(4)(ii)(A)(*2*) of this section.
U = Ultimate member's share of the upper-tier partnership's adjusted basis in its interest in the contributing partnership, determined according to the following formula: $H \times (B \div K)$.
H = Upper-tier partnership's adjusted basis in its interest in the contributing partnership.
B = Ultimate member's distributive share of the qualified conservation contribution.
K = Upper-tier partnership's allocated portion of the qualified conservation contribution.

(D) *Analysis: Step 1 for P*. With respect to P:

(*1*) M = $12X.

(*2*) J = $3.6X.

(*3*) H = $19X.

(*4*) B = $6X.

(*5*) K = $20X.

(*6*) Thus, U is $5.70X = $19X × ($6X ÷ $20X).

(*7*) Accordingly, the portion of P's modified basis that is allocable to UTP Partnership's interest in LTP Partnership is $7.35X = $12X × ($5.70X ÷ ($3.60X + $5.70X)).

(E) *Analysis: Step 1 for Q*. With respect to Q:

(*1*) M = $8X.

(*2*) J = $2.4X.

(*3*) H = $19X.

(*4*) B = $14X.

(*5*) K = $20X.

(*6*) Thus, U is $13.30X = $19X × ($14X ÷ $20X).

(*7*) Accordingly, the portion of Q's modified basis that is allocable to UTP Partnership's interest in LTP Partnership is $6.78X = $8X × ($13.30X ÷ ($2.40X + $13.30X)).

(F) *Analysis: General rule for LTP Partnership*. Next, LTP Partnership must determine P's and Q's relevant bases, which equal the portions of the amounts determined under paragraphs (m)(7)(iii)(D) and (E) of this section (*Example 3*) that are allocable to the portion of the real property with respect to which the qualified conservation contribution was made. This must be done according to the following formula:

Equation 11 to Paragraph (m)(7)(iii)(F)

$$R = G \times (V \div (L + V))$$

Where:

R = Relevant basis.
G = Amount determined with respect to item G under paragraph (m)(4)(ii)(B) of this section.
L = Upper-tier partnership's portion of adjusted basis in all the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.
V = Upper-tier partnership's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (K \div C)$.
A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.
K = Upper-tier partnership's allocated portion of the qualified conservation contribution.
C = Total amount of the contributing partnership's qualified conservation contribution.

(G) *Analysis: Step 2 for P*. With respect to P:

(*1*) G = $7.35X.

(*2*) L = $7.64X.

(*3*) A = $18X.

(*4*) K = $20X.

(*5*) C = $22X.

(*6*) Thus, V is $16.36X = $18X × ($20X ÷ $22X).

(*7*) Accordingly, P's relevant basis is $5.01X = $7.35X × ($16.36X ÷ ($7.64X + $16.36X)).

(H) *Analysis: Step 2 for Q*. With respect to Q:

(*1*) G = $6.78X.

(*2*) L = $7.64X.

(*3*) A = $18X.

(*4*) K = $20X.

(*5*) C = $22X.

(*6*) Thus, V is $16.36X = $18X × ($20X ÷ $22X).

(*7*) Accordingly, Q's relevant basis is $4.62X = $6.78X × ($16.36X ÷ ($7.64X + $16.36X)).

(I) *Analysis: Computation of 2.5 times sum of the relevant bases*. The ultimate members of LTP Partnership are E, P, and Q. The amount of LTP Partnership's qualified conservation contribution is $22X. This does not exceed 2.5

times the sum of each of the ultimate member's relevant basis, which totals \$26.80X (\$26.80X = 2.5 x (E's relevant basis of 1.09X + P's relevant basis of \$5.01X + Q's relevant basis of \$4.62X)). Therefore, LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and paragraph (j) of this section). Because UTP Partnership receives an allocated portion, it must apply paragraphs (j) through (l) of this section and this paragraph (m) to determine whether its allocated portion is a disallowed qualified conservation contribution. The ultimate members of UTP Partnership are P and Q. The amount of UTP Partnership's allocated portion of LTP Partnership's qualified conservation contribution is \$20X. This does not exceed 2.5 times the sum of P's and Q's relevant bases, which is \$24.08X (\$24.08X = 2.5 × (P's relevant basis of \$5.01X + Q's relevant basis of \$4.62X)). Therefore, UTP Partnership's allocated portion of LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and paragraph (j) of this section).

(iv) *Example 4*—(A) *Facts.* Individuals V and W form VW Partnership, a partnership for Federal income tax purposes. V and W each hold a fifty percent interest in all of VW Partnership's items of income, gain, loss, deduction, credits, and charitable contributions. On formation of VW Partnership, V contributes \$1,000X cash to VW Partnership and W contributes GainProp, which is non-depreciable property with a value of \$1,000X and basis of \$500X. VW Partnership buys real property (RealProp), with its \$1,000X cash. Later, at a time when VW Partnership's basis in RealProp is still \$1,000X, and its basis in GainProp is still \$500X, VW Partnership makes a qualified conservation contribution with respect to all of RealProp, which it allocates equally to V and W. VW Partnership continues to hold GainProp. V's modified basis is \$1,000X and W's modified basis is \$500X.

(B) *General analysis.* V and W are the ultimate members of VW Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. Their relevant bases must be determined according to the following formula:

Equation 12 to Paragraph (m)(7)(iv)(B)

$$R = M \times (T \div (D + T))$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

D = Ultimate member's portion of the adjusted basis in all of the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

T = Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (B \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

B = Ultimate member's distributive share of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(C) *V's relevant basis.* With respect to V:

(*1*) M = \$1,000X.

(*2*) D = \$250X (half of VW Partnership's adjusted basis in GainProp).

(*3*) T = \$500X (half of VW Partnership's adjusted basis in RealProp).

(*4*) Accordingly, V's relevant basis is \$666.67X = \$1,000X × (\$500X ÷ (\$250X + \$500X)).

(D) *W's relevant basis.* With respect to W:

(*1*) M = \$500X.

(*2*) D = \$250X (half of VW Partnership's basis in GainProp).

(*3*) T = \$500X (half of VW Partnership's adjusted basis in RealProp).

(*4*) Accordingly, W's relevant basis is \$333.33X = \$500X × (\$500X ÷ (\$250X + \$500X)).

(v) *Example 5*—(A) *Facts.* Assume the same facts as in paragraph (m)(7)(iv) of this section (*Example 4*), except that W does not contribute GainProp; instead, W contributes LossProp, which is non-depreciable property with a value of \$1,000X and basis of \$2,000X. At the time that VW Partnership makes the qualified conservation contribution on

RealProp, the value of LossProp is still \$1,000X and the basis of LossProp is still \$2,000X. V's modified basis is \$1,000X and W's modified basis is \$2,000X.

(B) *General analysis.* V and W are the ultimate members of VW Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. Their relevant bases must be determined according to the following formula:

Equation 13 to Paragraph (m)(7)(v)(B)

$$R = M \times (T \div (D + T))$$

Where:

R = Relevant basis.

M = Modified basis as determined under paragraph (l) of this section.

D = Ultimate member's portion of the adjusted basis in all of the contributing partnership's properties (other than the portion of the real property with respect to which the qualified conservation contribution is made) as determined under paragraph (m)(2)(iii)(B) of this section.

T = Ultimate member's share of the contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made, determined according to the following formula: $A \times (B \div C)$.

A = Contributing partnership's adjusted basis in the portion of the real property with respect to which the qualified conservation contribution is made.

B = Ultimate member's distributive share of the qualified conservation contribution.

C = Total amount of the contributing partnership's qualified conservation contribution.

(C) *V's relevant basis.* With respect to V:

(*1*) M = \$1,000X.

(*2*) D = \$500X (half of the \$1,000X portion of LossProp's adjusted basis that does not exceed LossProp's \$1,000X value)

(*3*) T = \$500X (half of VW Partnership's adjusted basis in RealProp)

(*4*) Accordingly, V's relevant basis is \$500X = \$1,000X × (\$500X ÷ (\$500X + \$500X)).

(D) *W's relevant basis.* With respect to W:

(*1*) M = \$2,000X.

(*2*) D = \$1,500X (half of the \$1,000X portion of LossProp's adjusted basis that does not exceed LossProp's \$1,000X value, plus all of the \$1,000X portion of LossProp's adjusted basis in excess of LossProp's \$1,000X value).

(*3*) T = \$500X (half of VW Partnership's adjusted basis in RealProp).

(*4*) Accordingly, W's relevant basis is \$500X = \$2,000X × (\$500X ÷ (\$1,500X + \$500X)).

(n) *Exceptions*—(1) *In general.* Paragraph (j) of this section does not apply to any qualified conservation contribution that satisfies one or more of the three exceptions in this paragraph (n). However, as provided in paragraph (j)(5) of this section, there is no presumption that a contribution that satisfies one or more of the three exceptions in this paragraph (n) is compliant with section 170, any other section of the Code, the regulations in this part, or any other guidance. Being described in this paragraph (n) is not a safe harbor for purposes of any other provision of law or with respect to the value of the contribution. Such transactions are subject to adjustment or disallowance for any other reason, including failure to satisfy other requirements of section 170 or overvaluation of the contribution. In addition, taxpayers who engage in transactions that satisfy one or more of the three exceptions in this paragraph (n) may nonetheless be required to disclose, under §1.6011–4, the transactions as listed transactions.

(2) *Exception for contributions outside three-year holding period*—(i) *In general.* Paragraph (j) of this section does not apply to any qualified conservation contribution by a contributing partnership or contributing S corporation made at least three years after the latest of—

(A) The last date on which the contributing partnership or contributing S corporation acquired any portion of the real property with respect to which such qualified conservation contribution is made;

(B) The last date on which any partner in the contributing partnership or shareholder in the contributing S corporation acquired any interest in such partnership or S corporation; and

(C) If the interest in the contributing partnership is held through one or more upper-tier partnerships or upper-tier S corporations—

(*1*) The last date on which any such upper-tier partnership or upper-tier S corporation acquired any interest in the contributing partnership or any other upper-tier partnership; and

(*2*) The last date on which any partner or shareholder in any such upper-tier partnership or upper-tier S corporation acquired any interest in such upper-tier partnership or upper-tier S corporation.

(ii) *Acquisition of partnership interest.* For purposes of this paragraph (n)(2), an acquisition of any interest in a partnership is any *variation* within the meaning of that term in § 1.706–4(a)(1); however, a variation does not include a change in allocations that satisfies the requirements of § 1.706–4(b)(1).

(iii) *Acquisition of interest in an S corporation.* For purposes of this paragraph (n)(2), an acquisition of any interest in an S corporation is any transfer, issuance, redemption, or other disposition of stock in the S corporation; however, an acquisition does not include any issuance or redemption involving all shareholders that does not affect the proportionate ownership of any shareholder.

(iv) *Exception is determined at the level of the contributing partnership or contributing S corporation.* If the contributing partnership or contributing S corporation does not satisfy the requirements of this paragraph (n)(2), then this paragraph (n)(2) will not apply to any person who receives a distributive share or pro rata share of the qualified conservation contribution (including an upper-tier partnership or upper-tier S corporation), regardless of whether the person receiving such distributive share or pro rata share would have satisfied the requirements of this paragraph (n)(2) if the person had been the one to make the qualified conservation contribution.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (n)(2). For the two examples in this paragraph (n)(2)(v), assume that the exceptions in paragraphs (n)(3) and (4) of this section do not apply.

(A) *Example 1*—(*1*) *Facts.* ABC Partnership is a partnership for Federal income tax purposes. Since 2015, ABC Partnership's partners have been A, an individual, and BC Inc., an S corporation. Since 2015, BC Inc.'s shareholders have been B and C, each of whom is an individual that is not a nonresident alien. On December 27, 2024, ABC Partnership acquires real property. On August 29, 2025, BC Inc. redeems half of B's shares in BC Inc. On December 28, 2027, ABC Partnership makes a qualified conservation contribution.

(*2*) *Analysis.* Pursuant to paragraph (n)(2)(iii) of this section, BC Inc.'s redemption of some of B's shares is treated as an acquisition of an interest in BC Inc. for purposes of this paragraph (n)(2). Accordingly, ABC Partnership's contribution occurred less than three years after the latest acquisition of an interest in a partnership or S corporation that held an interest in ABC Partnership, the contributing partnership. Therefore, ABC Partnership's contribution fails to satisfy the requirements of this paragraph (n)(2) and ABC Partnership must apply the provisions of paragraphs (j) through (m) of this section to determine whether the contribution is a disallowed qualified conservation contribution.

(B) *Example 2*—(*1*) *Facts.* LTP Partnership is a partnership for Federal income tax purposes. Since 2017, LTP Partnership's partners have been UTP Partnership, a partnership for Federal income tax purposes, and FG Inc., an S corporation. Since 2018, UTP Partnership's partners have been individuals D and E, and there has been no variation in their ownership. Since 2019, FG Inc.'s shareholders have been F and G, each of whom is an individual that is not a nonresident alien. On March 15, 2024, LTP Partnership acquires real property. On September 15, 2026, D dies and D's interest in UTP Partnership passes to D's estate. On March 18, 2027, LTP Partnership makes a qualified conservation contribution. LTP Partnership allocates all of the qualified conservation contribution to FG Inc.

(*2*) *Analysis.* Pursuant to paragraph (n)(2)(ii) of this section, the transfer of D's interest in UTP Partnership to D's estate is treated as an acquisition of an interest in UTP Partnership for purposes of this paragraph (n)(2). Accordingly, LTP Partnership's contribution occurred less than three years after the latest acquisition of an interest in a partnership or S corporation that held an interest in LTP Partnership, the contributing partnership. Therefore, LTP Partnership's contribution fails to satisfy the requirements of this paragraph (n)(2). Pursuant to paragraph (n)(2)(iv) of this section, FG Inc. cannot avail itself of this paragraph (n)(2) with respect to its allocated portion of LTP Partnership's contribution. Accordingly, FG Inc. must apply the provisions of paragraphs (j) through (m) of this section to determine whether its allocated portion is a disallowed qualified conservation contribution.

(3) *Exception for family partnerships and S corporations*—(i) *General rule.* Paragraph (j) of this section does not apply with respect to any qualified conservation contribution made by a contributing partnership or contributing S corporation if at least 90 percent of the interests in the contributing partnership or contributing S corporation are held by an individual and members of the family of such individual and the contributing partnership or contributing S corporation meets the requirements of this paragraph (n)(3).

(ii) *Ninety percent of the interests*—(A) *Family partnerships.* In the case of a contributing partnership, at least 90 percent of the interests in the contributing partnership are held by an individual and members of the family of such individual if, at the time of the qualified conservation contribution, at least 90 percent of the interests in capital and profits in such partnership are held, directly or indirectly, by an individual and members of the family of such individual.

(B) *Family S corporations.* In the case of a contributing S corporation, at least 90 percent of the interests in the contributing S corporation are held by an individual and members of the family of such individual if, at the time of the qualified conservation contribution, at least 90 percent of the total value and at least 90 percent of the total voting power of the outstanding stock in such S corporation are held by an individual and members of the family of such individual.

(iii) *Members of the family.* For purposes of this paragraph (n)(3), the term *members of the family* means, with respect to any individual—

(A) The spouse of such individual;

(B) Any individual who bears a relationship to such individual that is described in section 152(d)(2)(A) through (G) of the Code;

(C) The estate of a deceased individual who was described in paragraph (n)(3)(iii)(A) or (B) of this section at the time of death; and

(D) A trust all of the beneficiaries of which are individuals described in paragraph (n)(3)(iii)(A) or (B) of this section, treating as *beneficiaries* for this purpose those persons who currently must or may receive income or principal from the trust and those persons who would succeed to the property of the trust if the trust were to terminate immediately before the qualified conservation contribution.

(iv) *Anti-abuse rules*—(A) *Holding period.* This paragraph (n)(3) does not apply unless at least 90 percent of the interests in the property with respect to which the qualified conservation contribution was made were owned, directly or indirectly, by an individual and members of the family of that individual for at least one year prior to the date of the contribution. The members of the family during that year need not be the same members of the family that own an interest at the time of the qualified conservation contribution; however, at least one individual must own an interest for the entire year, and at least 90 percent of the interests in the property must be owned, directly or indirectly, during that year by that individual and members of that individual's family. Solely for purposes of this paragraph (n)(3)(iv)(A), section 1223(1) and (2) of the Code do not apply in determining whether at least ninety percent of the interests in the property with respect to which the qualified conservation contribution was made were owned, directly or indirectly, by one individual and members of the family of that individual for at least one year prior to the date of the contribution. This paragraph (n)(3)(iv)(A) does not apply if the entire amount of the qualified conservation contribution is limited by section 170(e) to the contributing partnership's or contributing S corporation's adjusted basis in the qualified conservation contribution.

(B) *Allocations*. This paragraph (n)(3) does not apply unless at least 90 percent of the qualified conservation contribution is allocated to the individual and all members of the family who own at least 90 percent of the interests in the contributing partnership or contributing S corporation under paragraph (n)(3)(ii) of this section.

(v) *Exception is determined at the level of the contributing partnership or contributing S corporation*. If the contributing partnership or contributing S corporation satisfies the requirements of this paragraph (n)(3), then any upper-tier partnership or upper-tier S corporation need not apply paragraphs (j) through (m) of this section and this paragraph (n) to its allocated portions of such contribution. If the contributing partnership or contributing S corporation does not satisfy the requirements of this paragraph (n)(3), then the exception in this paragraph (n)(3) will not apply to any person who receives a distributive share or pro rata share of the qualified conservation contribution (including an upper-tier partnership or upper-tier S corporation), regardless of whether the person receiving such distributive share or pro rata share would have satisfied the requirements of this paragraph (n)(3) if the person had been the one to make the contribution.

(vi) *Examples*. The following examples illustrate the provisions of this paragraph (n)(3). For the two examples in this paragraph (n)(3)(vi), assume that the exceptions in paragraphs (n)(2) and (4) of this section do not apply.

(A) *Example 1*—(*1*) *Facts*. Individual A and A's sibling B acquire real property by purchase on July 5, 2024. On September 14, 2024, B transfers its interest in the real property to B's child C. On February 21, 2025, A and C transfer their interests in the real property to AC Partnership, a partnership for Federal income tax purposes whose only partners are A and C. On March 18, 2025, A's stepfather D becomes a partner in AC Partnership in exchange for a capital contribution. On September 15, 2025, AC Partnership makes a qualified conservation contribution on the real property. AC Partnership never had any partners other than A, C, and D.

(*2*) *Analysis*. B, C, and D qualify as members of the family with respect to A. Accordingly, as of the time of the qualified conservation contribution, at least 90 percent of the interests in capital and profits of AC Partnership were owned by an individual and members of that individual's family. In addition, at least 90 percent of the interests in the property with respect to which the qualified conservation contribution was made were owned, directly and indirectly, by A and members of A's family for at least one year prior to the date of the contribution. Moreover, at least 90 percent of the contribution is allocated to A and members of A's family. Accordingly, the requirements of this paragraph (n)(3) are satisfied, and the Disallowance Rule in section 170(h)(7)(A) and paragraph (j) of this section does not apply.

(B) *Example 2*—(*1*) *Facts*. LTP Partnership is a partnership for Federal income tax purposes whose partners are EF Inc., an S corporation, and UTP Partnership, a partnership for Federal income tax purposes. EF Inc. and UTP Partnership each hold a 50 percent interest in the profits and capital of LTP Partnership. The shareholders of EF Inc. are E and E's sibling F. The partners of UTP Partnership are G and G's child H. E and F are not related to G and H. LTP Partnership has held real property since 2019. On July 5, 2024, LTP Partnership distributes half of the acres of its real property to EF Inc., and the remaining acres to UTP Partnership. On October 21, 2024, EF Inc., makes a qualified conservation contribution on the real property it received from LTP Partnership. The amount of EF Inc.'s qualified conservation contribution is not limited by section 170(e).

(*2*) *Analysis*. F qualifies as a member of the family with respect to E. Accordingly, as of the time of EF Inc.'s qualified conservation contribution, EF Inc. was owned at least 90 percent by an individual and members of that individual's family. In addition, at least 90 percent of EF Inc's qualified conservation contribution is allocated to E and members of E's family. However, E and members of E's family failed to own at least 90 percent of the property with respect to which the qualified conservation contribution was made for at least one year prior to the date of the contribution. In particular, G and H (who are not members of the family with respect to E or F) indirectly owned a 50 percent interest in the property until July 5, 2024. Accordingly, the requirements of this paragraph (n)(3) are not satisfied. EF Inc. must apply the provisions of paragraphs (j) through (m) of this section to determine whether the contribution is a disallowed qualified conservation contribution. If the entire amount of EF Inc.'s qualified conservation contribution had been limited by section 170(e) to EF Inc.'s adjusted basis in the qualified conservation contribution, then paragraph (n)(3)(iv)(A) of this section would not have applied; accordingly, the requirements of this paragraph (n)(3) would have been satisfied, and the Disallowance Rule in section 170(h)(7)(A) and paragraph (j) of this section would not have applied.

(4) *Exception for contributions to preserve certified historic structures.* Paragraph (j) of this section does not apply to any qualified conservation contribution the conservation purpose of which is the preservation of any building that is a certified historic structure (as defined in section 170(h)(4)(C)). *See* § 1.170A–16(f)(6) for special reporting requirements for a contribution that meets the exception in this paragraph (n)(4).

(o) *Applicability dates*—(1) *In general.* Except as provided in paragraphs (g)(4)(ii), (i), and (o)(2) of this section, paragraphs (a) through (i) of this section apply only to contributions made on or after December 18, 1980. Paragraphs (j) through (n) of this section apply to contributions made after December 29, 2022.

(2) *Exception.* Paragraph (h)(4)(ii) of this section applies on and after June 1, 2023.

[T.D. 8069, 51 FR 1499, Jan. 14, 1986; 51 FR 5322, Feb. 13, 1986; 51 FR 6219, Feb. 21, 1986, as amended by T.D. 8199, 53 FR 16085, May 5, 1988; T.D. 8540, 59 FR 30105, June 10, 1994; T.D. 8819, 64 FR 23228, Apr. 30, 1999; T.D. 9448, 74 FR 21518, May 7, 2009; T.D. 9836, 83 FR 36422, July 30, 2018; T.D. 9974, 88 FR 37429, June 7, 2023; T.D. 9999, 89 FR 54311, June 28, 2024; 89 FR 70486, Aug. 30, 2024]

§ 1.170A–15 Substantiation requirements for charitable contribution of a cash, check, or other monetary gift.

(a) *In general*—(1) *Bank record or written communication required.* No deduction is allowed under sections 170(a) and 170(f)(17) for a charitable contribution in the form of a cash, check, or other monetary gift, as described in paragraph (b)(1) of this section, unless the donor substantiates the deduction with a bank record, as described in paragraph (b)(2) of this section, or a written communication, as described in paragraph (b)(3) of this section, from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution.

(2) *Additional substantiation required for contributions of $250 or more.* No deduction is allowed under section 170(a) for any contribution of $250 or more unless the donor substantiates the contribution with a contemporaneous written acknowledgment, as described in section 170(f)(8) and § 1.170A–13(f), from the donee.

(3) *Single document may be used.* The requirements of paragraphs (a)(1) and (2) of this section may be met by a single document that contains all the information required by paragraphs (a)(1) and (2) of this section, if the document is obtained by the donor no later than the date prescribed by paragraph (c) of this section.

(b) *Terms*—(1) *Monetary gift* includes a transfer of a gift card redeemable for cash, and a payment made by credit card, electronic fund transfer (as described in section 5061(e)(2)), an online payment service, or payroll deduction.

(2) *Bank record* includes a statement from a financial institution, an electronic fund transfer receipt, a canceled check, a scanned image of both sides of a canceled check obtained from a bank website, or a credit card statement.

(3) *Written communication* includes email.

(c) *Deadline for receipt of substantiation.* The substantiation described in paragraph (a) of this section must be received by the donor on or before the earlier of—

(1) The date the donor files the original return for the taxable year in which the contribution was made; or

(2) The due date, including any extension, for filing the donor's original return for that year.

(d) *Special rules*—(1) *Contributions made by payroll deduction.* In the case of a charitable contribution made by payroll deduction, a donor is treated as meeting the requirements of section 170(f)(17) and paragraph (a) of this section if, no later than the date described in paragraph (c) of this section, the donor obtains—

(i) A pay stub, Form W–2, ''Wage and Tax Statement,'' or other employer-furnished document that sets forth the amount withheld during the taxable year for payment to a donee; and

(ii) A pledge card or other document prepared by or at the direction of the donee that shows the name of the donee.

(2) *Distributing organizations as donees.* The following organizations are treated as donees for purposes of section 170(f)(17) and paragraph (a) of this section, even if the organization (pursuant to the donor's instructions or otherwise) distributes the amount received to one or more organizations described in section 170(c):

(i) An organization described in section 170(c).

(ii) An organization described in 5 CFR 950.105 (a Principal Combined Fund Organization (PCFO) for purposes of the Combined Federal Campaign (CFC)) and acting in that capacity. For purposes of the requirement for a written communication under section 170(f)(17), if the donee is a PCFO, the name of the local CFC campaign may be treated as the name of the donee organization.

(e) *Substantiation of out-of-pocket expenses.* Paragraph (a)(1) of this section does not apply to a donor who incurs unreimbursed expenses of less than $250 incident to the rendition of services, within the meaning of §1.170A–1(g). For substantiation of unreimbursed out-of-pocket expenses of $250 or more, see §1.170A–13(f)(10).

(f) *Charitable contributions made by partnership or S corporation.* If a partnership or an S corporation makes a charitable contribution, the partnership or S corporation is treated as the donor for purposes of section 170(f)(17) and paragraph (a) of this section.

(g) *Transfers to certain trusts.* The requirements of section 170(f)(17) and paragraphs (a)(1) and (3) of this section do not apply to a transfer of a cash, check, or other monetary gift to a trust described in section 170(f)(2)(B); a charitable remainder annuity trust, as described in section 664(d)(1) and the corresponding regulations; or a charitable remainder unitrust, as described in section 664(d)(2) or (d)(3) and the corresponding regulations. The requirements of section 170(f)(17) and paragraphs (a)(1) and (2) of this section do apply, however, to a transfer to a pooled income fund, as defined in section 642(c)(5).

(h) *Effective/applicability date.* This section applies to contributions made after July 30, 2018. Taxpayers may rely on the rules of this section for contributions made in taxable years beginning after August 17, 2006.

[T.D. 9836, 83 FR 36422, July 30, 2018]

§ 1.170A–16 Substantiation and reporting requirements for noncash charitable contributions.

(a) *Substantiation of charitable contributions of less than $250*—(1) *Individuals, partnerships, and certain corporations required to obtain receipt.* Except as provided in paragraph (a)(2) of this section, no deduction is allowed under section 170(a) for a noncash charitable contribution of less than $250 by an individual, partnership, S corporation, or C corporation that is a personal service corporation or closely held corporation unless the donor maintains for each contribution a receipt from the donee showing the following information:

(i) The name and address of the donee;

(ii) The date of the contribution;

(iii) A description of the property in sufficient detail under the circumstances (taking into account the value of the property) for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property; and

(iv) In the case of securities, the name of the issuer, the type of security, and whether the securities are publicly traded securities within the meaning of §1.170A–13(c)(7)(xi).

(2) *Substitution of reliable written records*—(i) *In general.* If it is impracticable to obtain a receipt (for example, where a donor deposits property at a donee's unattended drop site), the donor may satisfy the recordkeeping rules of this paragraph (a) by maintaining reliable written records, as described in paragraphs (a)(2)(ii) and (iii) of this section, for the contributed property.

(ii) *Reliable written records.* The reliability of written records is to be determined on the basis of all of the facts and circumstances of a particular case, including the proximity in time of the written record to the contribution.

(iii) *Contents of reliable written records.* Reliable written records must include—

(A) The information required by paragraph (a)(1) of this section;

(B) The fair market value of the property on the date the contribution was made;

(C) The method used in determining the fair market value; and

(D) In the case of a contribution of clothing or a household item as defined in §1.170A–18(c), the condition of the item.

(3) *Additional substantiation rules may apply.* For additional substantiation rules, see paragraph (f) of this section.

(b) *Substantiation of charitable contributions of $250 or more but not more than $500.* No deduction is allowed under section 170(a) for a noncash charitable contribution of $250 or more but not more than $500 unless the donor substantiates the contribution with a contemporaneous written acknowledgment, as described in section 170(f)(8) and §1.170A–13(f).

(c) *Substantiation of charitable contributions of more than $500 but not more than $5,000*—(1) *In general.* No deduction is allowed under section 170(a) for a noncash charitable contribution of more than $500 but not more than $5,000 unless the donor substantiates the contribution with a contemporaneous written acknowledgment, as described in section 170(f)(8) and §1.170A–13(f), and meets the applicable requirements of this section.

(2) *Individuals, partnerships, and certain corporations also required to file Form 8283 (Section A).* No deduction is allowed under section 170(a) for a noncash charitable contribution of more than $500 but not more than $5,000 by an individual, partnership, S corporation, or C corporation that is a personal service corporation or closely held corporation unless the donor completes Form 8283 (Section A), ''Noncash Charitable Contributions,'' as provided in paragraph (c)(3) of this section, or a successor form, and files it with the return on which the deduction is claimed.

(3) *Completion of Form 8283 (Section A).* A completed Form 8283 (Section A) includes—

(i) The donor's name and taxpayer identification number (for example, a social security number or employer identification number);

(ii) The name and address of the donee;

(iii) The date of the contribution;

(iv) The following information about the contributed property:

(A) A description of the property in sufficient detail under the circumstances, taking into account the value of the property, for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property;

(B) In the case of real or tangible personal property, the condition of the property;

(C) In the case of securities, the name of the issuer, the type of security, and whether the securities are publicly traded securities within the meaning of §1.170A–13(c)(7)(xi);

(D) The fair market value of the property on the date the contribution was made and the method used in determining the fair market value;

(E) The manner of acquisition (for example, by purchase, gift, bequest, inheritance, or exchange), and the approximate date of acquisition of the property by the donor (except that in the case of a contribution of publicly traded securities as defined in §1.170A–13(c)(7)(xi), a representation that the donor held the securities for more than one year is sufficient) or, if the property was created, produced, or manufactured by or for the donor, the approximate date the property was substantially completed;

(F) The cost or other basis, adjusted as provided by section 1016, of the property (except that the cost or basis is not required for contributions of publicly traded securities (as defined in § 1.170A–13(c)(7)(xi)) that would have resulted in long-term capital gain if sold on the contribution date, unless the donor has elected to limit the deduction to basis under section 170(b)(1)(C)(iii)); and

(G) In the case of tangible personal property, whether the donee has certified it for a use related to the purpose or function constituting the donee's basis for exemption under section 501, or in the case of a governmental unit, an exclusively public purpose;

(v) If a number can be inserted into any box on Form 8283 (Section A), the number inserted in the box on Form 8283 (Section A). Alternatively, taxpayers may attach a statement to the Form 8283 explaining why a number cannot be inserted. Nothing in this paragraph (c)(3)(v) precludes a taxpayer from both inserting the number in the appropriate box on Form 8283 (Section A) and including an attached statement explaining any additional information regarding the number. Taxpayers may not respond to a request for information on Form 8283 (Section A) with nonresponsive language; for example, by indicating that the requested information is *available upon request* or will be *provided upon request*. The inclusion of such nonresponsive language in response to a request for information on Form 8283 (Section A) may be treated by the IRS as being an incomplete filing of Form 8283; and

(vi) Any other information required by Form 8283 (Section A) or the instructions to Form 8283 (Section A).

(4) *Additional requirement for certain vehicle contributions.* In the case of a contribution of a qualified vehicle described in section 170(f)(12)(E) for which an acknowledgment by the donee organization is required under section 170(f)(12)(D), the donor must attach a copy of the acknowledgment to the Form 8283 (Section A) for the return on which the deduction is claimed.

(5) *Additional substantiation rules may apply.* For additional substantiation rules, see paragraph (f) of this section.

(d) *Substantiation of charitable contributions of more than $5,000*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, no deduction is allowed under section 170(a) for a noncash charitable contribution of more than $5,000 unless the donor—

(i) Substantiates the contribution with a contemporaneous written acknowledgment, as described in section 170(f)(8) and § 1.170A–13(f);

(ii) Obtains a qualified appraisal, as defined in § 1.170A–17(a)(1), prepared by a qualified appraiser, as defined in § 1.170A–17(b)(1); and

(iii) Completes Form 8283 (Section B), as provided in paragraph (d)(3) of this section, or a successor form, and files it with the return on which the deduction is claimed.

(2) *Exception for certain noncash contributions.* A qualified appraisal is not required, and a completed Form 8283 (Section A) containing the information required in paragraph (c)(3) of this section meets the requirements of paragraph (d)(1)(iii) of this section for contributions of—

(i) Publicly traded securities as defined in § 1.170A–13(c)(7)(xi);

(ii) Property described in section 170(e)(1)(B)(iii) (certain intellectual property);

(iii) A qualified vehicle described in section 170(f)(12)(A)(ii) for which an acknowledgment under section 170(f)(12)(B)(iii) is provided; and

(iv) Property described in section 1221(a)(1) (inventory and property held by the donor primarily for sale to customers in the ordinary course of the donor's trade or business).

(3) *Completed Form 8283 (Section B).* A completed Form 8283 (Section B) includes—

(i) The donor's name and taxpayer identification number (for example, a social security number or employer identification number);

(ii) The donee's name, address, taxpayer identification number, signature, the date signed by the donee, and the date the donee received the property;

(iii) The appraiser's name, address, taxpayer identification number, appraiser declaration, as described in paragraph (d)(4) of this section, signature, and the date signed by the appraiser;

(iv) The following information about the contributed property:

(A) The fair market value on the valuation effective date, as defined in § 1.170A–17(a)(5)(i).

(B) A description in sufficient detail under the circumstances, taking into account the value of the property, for a person who is not generally familiar with the type of property to ascertain that the described property is the contributed property.

(C) In the case of real property or tangible personal property, the condition of the property;

(v) The manner of acquisition (for example, by purchase, gift, bequest, inheritance, or exchange), and the approximate date of acquisition of the property by the donor, or, if the property was created, produced, or manufactured by or for the donor, the approximate date the property was substantially completed;

(vi) The cost or other basis of the property, adjusted as provided by section 1016;

(vii) A statement explaining whether the charitable contribution was made by means of a bargain sale and, if so, the amount of any consideration received for the contribution;

(viii) In the case of a partnership or S corporation that makes a qualified conservation contribution, the sum of each ultimate member's relevant basis, computed in accordance with § 1.170A–14(j) through (m), but only:

(A) For contributions described in section 170(h)(7)(E) and § 1.170A–14(n)(4) (for contributions to preserve certified historic structures), regardless of whether they are also described in section 170(h)(7)(C) and § 1.170A–14(n)(2) (for contributions made outside of the three-year holding period) and/or section 170(h)(7)(D) and § 1.170A–14(n)(3) (for contributions made by certain family partnerships or S corporations); and

(B) For all contributions not described in section 170(h)(7)(E) and § 1.170A–14(n)(4), provided they are not described in section 170(h)(7)(C) and § 1.170A–14(n)(2) (for contributions made outside of the three-year holding period) and/or section 170(h)(7)(D) and § 1.170A–14(n)(3) (for contributions made by certain family partnerships or S corporations);

(ix) If a number can be inserted into any box on Form 8283 (Section B), the number inserted in the box on Form 8283 (Section B). Alternatively, taxpayers may attach a statement to the Form 8283 explaining why a number cannot be inserted. Nothing in this paragraph (d)(3)(ix) precludes a taxpayer from both inserting the number in the appropriate box on Form 8283 (Section B) and including an attached statement explaining any additional information regarding the number. Taxpayers may not respond to a request for information on Form 8283 (Section B) with nonresponsive language; for example, by indicating that the requested information is *available upon request* or will be *provided upon request*. The inclusion of such nonresponsive language in response to a request for information on Form 8283 (Section B) may be treated by the IRS as being an incomplete filing of Form 8283; and

(x) Any other information required by Form 8283 (Section B) or the instructions to Form 8283 (Section B).

(4) *Appraiser declaration*. The appraiser declaration referred to in paragraph (d)(3)(iii) of this section must include the following statement: ''I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. 330(c).''

(5) *Donee signature*—(i) *Person authorized to sign*. The person who signs Form 8283 (Section B) for the donee must be either an official authorized to sign the tax or information returns of the donee, or a person specifically authorized to sign Forms 8283 (Section B) by that official. In the case of a donee that is a governmental unit, the person

who signs Form 8283 (Section B) for the donee must be an official of the governmental unit.

(ii) *Effect of donee signature.* The signature of the donee on Form 8283 (Section B) does not represent concurrence in the appraised value of the contributed property. Rather, it represents acknowledgment of receipt of the property described in Form 8283 (Section B) on the date specified in Form 8283 (Section B) and that the donee understands the information reporting requirements imposed by section 6050L and § 1.6050L–1.

(iii) *Certain information not required on Form 8283 (Section B) before donee signs.* Before Form 8283 (Section B) is signed by the donee, Form 8283 (Section B) must be completed (as described in paragraph (d)(3) of this section), except that it is not required to contain the following:

(A) The appraiser declaration or information about the qualified appraiser.

(B) The manner or date of acquisition.

(C) The cost or other basis of the property.

(D) The appraised fair market value of the contributed property.

(E) The amount claimed as a charitable contribution.

(6) *Additional substantiation rules may apply.* For additional substantiation rules, see paragraph (f) of this section.

(7) *More than one appraiser.* More than one appraiser may appraise the donated property. If more than one appraiser appraises the property, the donor does not have to use each appraiser's appraisal for purposes of substantiating the charitable contribution deduction under this paragraph (d). If the donor uses the appraisal of more than one appraiser, or if two or more appraisers contribute to a single appraisal, each appraiser shall comply with the requirements of this paragraph (d) and the requirements in § 1.170A–17, including signing the qualified appraisal and appraisal summary.

(e) *Substantiation of noncash charitable contributions of more than $500,000*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, no deduction is allowed under section 170(a) for a noncash charitable contribution of more than $500,000 unless the donor—

(i) Substantiates the contribution with a contemporaneous written acknowledgment, as described in section 170(f)(8) and § 1.170A–13(f);

(ii) Obtains a qualified appraisal, as defined in § 1.170A–17(a)(1), prepared by a qualified appraiser, as defined in § 1.170A–17(b)(1);

(iii) Completes, as described in paragraph (d)(3) of this section, Form 8283 (Section B) and files it with the return on which the deduction is claimed; and

(iv) Attaches the qualified appraisal of the property to the return on which the deduction is claimed.

(2) *Exception for certain noncash contributions.* For contributions of property described in paragraph (d)(2) of this section, a qualified appraisal is not required, and a completed Form 8283 (Section A), containing the information required in paragraph (c)(3) of this section, meets the requirements of paragraph (e)(1)(iii) of this section.

(3) *Additional substantiation rules may apply.* For additional substantiation rules, see paragraph (f) of this section.

(f) *Additional substantiation rules*—(1) *Form 8283 (Section B) furnished by donor to donee.* A donor who presents a Form 8283 (Section B) to a donee for signature must furnish to the donee a copy of the Form 8283 (Section B).

(2) *Number of Forms 8283 (Section A or Section B)*—(i) *In general.* For each item of contributed property for which a Form 8283 (Section A or Section B) is required under paragraphs (c), (d), or (e) of this section, a donor must attach a separate Form 8283 (Section A or Section B) to the return on which the deduction for the item is claimed.

(ii) *Exception for similar items.* The donor may attach a single Form 8283 (Section A or Section B) for all similar items of property, as defined in § 1.170A–13(c)(7)(iii), contributed to the same donee during the donor's taxable year, if the donor includes on Form 8283 (Section A or Section B) the information required by paragraph (c)(3) or (d)(3) of this section for each item of property.

(3) *Substantiation requirements for carryovers of noncash contribution deductions.* The rules in paragraphs (c), (d),

and (e) of this section (regarding substantiation that must be submitted with a return) also apply to the return for any carryover year under section 170(d).

(4) *Partners and S corporation shareholders*—(i) *Form 8283 (Section A or Section B) must be provided to partners and S corporation shareholders.* If the donor is a partnership or an S corporation, the donor must provide a copy of its completed Form 8283 (Section A or Section B) to every partner or shareholder who receives an allocation of a charitable contribution under section 170 for the property described in Form 8283 (Section A or Section B). Similarly, a recipient partner that is a partnership or S corporation must provide a copy of the donor's completed Form 8283 (Section A or Section B) to each of its partners or shareholders who receives an allocation of the charitable contribution, and so on through any additional tiers.

(ii) *Partners and S corporation shareholders must attach Forms 8283 (Section A or Section B) to return.* A partner of a partnership or shareholder of an S corporation who receives an allocation of a charitable contribution under section 170 for property to which paragraph (c), (d), or (e) of this section applies must attach to the return on which the contribution is claimed a copy of each Form 8283 that must be provided to them under paragraph (f)(4)(i) or (iii) of this section.

(iii) *Partners and S corporation shareholders must file separate Forms 8283 and provide copies to any partners*—(A) *In general.* Subject to paragraph (f)(4)(iii)(B) of this section, every partner of a partnership (including a partner that is itself a partnership or S corporation) or shareholder of an S corporation that receives an allocation of a charitable contribution under section 170 for which paragraph (c), (d), or (e) of this section applies must complete a separate Form 8283 with any information required by Form 8283 and the instructions to Form 8283. In the case of a partner that is itself a partnership or S corporation, that partnership or S corporation must provide a copy of its completed separate Form 8283 to every partner or shareholder who receives an allocation of the charitable contribution, and so on through any additional tiers. The partner or shareholder must attach its separate Form 8283 to the return on which the contribution is claimed, in addition to the copy of each Form 8283 that the partner or shareholder is required to attach pursuant to paragraph (f)(4)(ii) of this section.

(B) *Conservation contributions.* The terms defined in §1.170A–14(j)(3) apply for purposes of this paragraph (f)(4)(iii)(B). In the case of a qualified conservation contribution that is made by a partnership or S corporation, an ultimate member's separate Form 8283 must include their own relevant basis. An upper-tier partnership's or upper-tier S corporation's separate Form 8283 must include the sum of each of its ultimate member's relevant basis (as computed in accordance with §1.170A–14(j) through (m)). This paragraph (f)(4)(iii)(B) does not apply to contributions described in section 170(h)(7)(C) and §1.170A–14(n)(2) (for contributions made outside of the three-year holding period) or section 170(h)(7)(D) and §1.170A–14(n)(3) (for contributions made by certain family partnerships or S corporations), provided that they are not also described in section 170(h)(7)(E) and §1.170A–14(n)(4) (for contributions to preserve certified historic structures), in which case this paragraph (f)(4)(iii)(B) does apply.

(5) *Determination of deduction amount for purposes of substantiation rules*—(i) *In general.* In determining whether the amount of a donor's deduction exceeds the amounts set forth in section 170(f)(11)(B) (noncash contributions exceeding $500), 170(f)(11)(C) (noncash contributions exceeding $5,000), or 170(f)(11)(D) (noncash contributions exceeding $500,000), the rules of paragraphs (f)(5)(ii) and (iii) of this section apply.

(ii) *Similar items of property must be aggregated.* Under section 170(f)(11)(F), the donor must aggregate the amount claimed as a deduction for all similar items of property, as defined in §1.170A–13(c)(7)(iii), contributed during the taxable year. For rules regarding the number of qualified appraisals and Forms 8283 (Section A or Section B) required if similar items of property are contributed, see §1.170A–13(c)(3)(iv)(A) and (4)(iv)(B).

(iii) *For contributions of certain inventory and scientific property, excess of amount claimed over cost of goods sold taken into account*—(A) *In general.* In determining the amount of a donor's contribution of property to which section 170(e)(3) (relating to contributions of inventory and other property) or (e)(4) (relating to contributions of scientific property used for research) applies, the donor must take into account only the excess of the amount claimed as a deduction over the amount that would have been treated as the cost of goods sold if the donor had sold the contributed property to the donee.

(B) *Example.* The following example illustrates the rule of this paragraph (f)(5)(iii):

Example. X Corporation makes a contribution of inventory described in section 1221(a)(2). The contribution, described in section 170(e)(3), is for the care of the needy. The cost of the property to *X* Corporation is $5,000 and the fair market value of the property at the time of the contribution is $11,000. Pursuant to section 170(e)(3)(B), *X* Corporation claims a charitable contribution deduction of $8,000 ($5,000 + ½ × ($11,000 − 5,000) = $8,000). The amount taken into account for purposes of determining the $5,000 threshold of paragraph (d) of this section is $3,000 ($8,000 − $5,000).

(6) *Conservation contributions by pass-through entities preserving certified historic structures*—(i) *In general.* The terms defined in §1.170A–14(j)(3) apply for purposes of this paragraph (f)(6). For any contribution described in paragraph (f)(6)(ii) of this section, pursuant to section 170(f)(19), no deduction is allowed under section 170 or any other provision of the Code under which deductions are allowable to pass-through entities with respect to such contribution unless the contributing partnership, the contributing S corporation, the upper-tier partnership, or the upper-tier S corporation, respectively—

(A) Includes on its return for the taxable year in which the contribution is made a statement that it made such a contribution or received such allocated portion, as described in paragraph (f)(6)(iii) of this section; and

(B) Provides such information about the contribution as the Secretary of the Treasury or her delegate may require in guidance, forms, or instructions.

(ii) *Contributions to which this paragraph (f)(6) applies.* This paragraph (f)(6) applies to any qualified conservation contribution (as defined in section 170(h)(1) and §1.170A–14):

(A) The conservation purpose of which is preservation of a building that is a certified historic structure (as defined in section 170(h)(4)(C));

(B) That is either:

(*1*) Made by a contributing partnership (as defined in §1.170A–14(j)(3)(iii)) or contributing S corporation (as defined in §1.170A–14(j)(3)(iv)); or

(*2*) Is an allocated portion (as defined in §1.170A–14(j)(3)(i)) of an upper-tier partnership (as defined in §1.170A–14(j)(3)(xi)) or upper-tier S corporation (as defined in §1.170A–14(j)(3)(xii)); and

(C) The amount of such contribution (as defined in §1.170A–14(j)(3)(ii)) or such allocated portion (as defined in §1.170A–14(j)(3)(i)) exceeds 2.5 times the sum of each ultimate member's relevant basis (as defined in §1.170A–14(j) through (m)).

(iii) *Required information.* A partnership or S corporation satisfies the requirements of section 170(f)(19)(A) and paragraph (f)(6)(i) of this section by filing a completed Form 8283, including information about relevant basis, in accordance with section 170, the regulations under section 170, and the instructions to Form 8283.

(g) *Applicability dates*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to contributions made after July 30, 2018.

(2) *Certain paragraphs.* Paragraphs (c)(3)(v), (d)(3)(viii) and (ix), and (f)(4) and (6) of this section apply to taxable years ending on or after November 20, 2023.

[T.D.9836, 83 FR 36423, July 30, 2018, as amended by T.D. 9999, 89 FR 54325, June 28, 2024; 89 FR 70486, Aug. 30, 2024]

§1.170A–17 Qualified appraisal and qualified appraiser.

(a) *Qualified appraisal*—(1) *Definition.* For purposes of section 170(f)(11) and §1.170A–16(d)(1)(ii) and (e)(1)(ii), the term *qualified appraisal* means an appraisal document that is prepared by a qualified appraiser (as defined in paragraph (b)(1) of this section) in accordance with generally accepted appraisal standards (as defined in paragraph (a)(2) of this section) and otherwise complies with the requirements of this paragraph (a).

(2) *Generally accepted appraisal standards defined.* For purposes of paragraph (a)(1) of this section, *generally accepted appraisal standards* means the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation.

(3) *Contents of qualified appraisal.* A qualified appraisal must include—

(i) The following information about the contributed property:

(A) A description in sufficient detail under the circumstances, taking into account the value of the property, for a person who is not generally familiar with the type of property to ascertain that the appraised property is the contributed property.

(B) In the case of real property or tangible personal property, the condition of the property.

(C) The valuation effective date, as defined in paragraph (a)(5)(i) of this section.

(D) The fair market value, within the meaning of §1.170A–1(c)(2), of the contributed property on the valuation effective date;

(ii) The terms of any agreement or understanding by or on behalf of the donor and donee that relates to the use, sale, or other disposition of the contributed property, including, for example, the terms of any agreement or understanding that—

(A) Restricts temporarily or permanently a donee's right to use or dispose of the contributed property;

(B) Reserves to, or confers upon, anyone, other than a donee or an organization participating with a donee in cooperative fundraising, any right to the income from the contributed property or to the possession of the property, including the right to vote contributed securities, to acquire the property by purchase or otherwise, or to designate the person having income, possession, or right to acquire; or

(C) Earmarks contributed property for a particular use;

(iii) The date, or expected date, of the contribution to the donee;

(iv) The following information about the appraiser:

(A) Name, address, and taxpayer identification number.

(B) Qualifications to value the type of property being valued, including the appraiser's education and experience.

(C) If the appraiser is acting in his or her capacity as a partner in a partnership, an employee of any person, whether an individual, corporation, or partnership, or an independent contractor engaged by a person other than the donor, the name, address, and taxpayer identification number of the partnership or the person who employs or engages the qualified appraiser;

(v) The signature of the appraiser and the date signed by the appraiser (appraisal report date);

(vi) The following declaration by the appraiser: ''I understand that my appraisal will be used in connection with a return or claim for refund. I also understand that, if there is a substantial or gross valuation misstatement of the value of the property claimed on the return or claim for refund that is based on my appraisal, I may be subject to a penalty under section 6695A of the Internal Revenue Code, as well as other applicable penalties. I affirm that I have not been at any time in the three-year period ending on the date of the appraisal barred from presenting evidence or testimony before the Department of the Treasury or the Internal Revenue Service pursuant to 31 U.S.C. 330(c)'';

(vii) A statement that the appraisal was prepared for income tax purposes;

(viii) The method of valuation used to determine the fair market value, such as the income approach, the market-data approach, or the replacement-cost-less-depreciation approach; and

(ix) The specific basis for the valuation, such as specific comparable sales transactions or statistical sampling, including a justification for using sampling and an explanation of the sampling procedure employed.

(4) *Timely appraisal report.* A qualified appraisal must be signed and dated by the qualified appraiser no earlier than

60 days before the date of the contribution and no later than—

(i) The due date, including extensions, of the return on which the deduction for the contribution is first claimed;

(ii) In the case of a donor that is a partnership or S corporation, the due date, including extensions, of the return on which the deduction for the contribution is first reported; or

(iii) In the case of a deduction first claimed on an amended return, the date on which the amended return is filed.

(5) *Valuation effective date*—(i) *Definition.* The *valuation effective date* is the date to which the value opinion applies.

(ii) *Timely valuation effective date.* For an appraisal report dated before the date of the contribution, as described in §1.170A–1(b), the valuation effective date must be no earlier than 60 days before the date of the contribution and no later than the date of the contribution. For an appraisal report dated on or after the date of the contribution, the valuation effective date must be the date of the contribution.

(6) *Exclusion for donor knowledge of falsity.* An appraisal is not a qualified appraisal for a particular contribution, even if the requirements of this paragraph (a) are met, if the donor either failed to disclose or misrepresented facts, and a reasonable person would expect that this failure or misrepresentation would cause the appraiser to misstate the value of the contributed property.

(7) *Number of appraisals required.* A donor must obtain a separate qualified appraisal for each item of property for which an appraisal is required under section 170(f)(11)(C) and (D) and paragraph (d) or (e) of §1.170A–16 and that is not included in a group of similar items of property, as defined in §1.170A–13(c)(7)(iii). For rules regarding the number of appraisals required if similar items of property are contributed, see section 170(f)(11)(F) and §1.170A–13(c)(3)(iv)(A).

(8) *Time of receipt of qualified appraisal.* The qualified appraisal must be received by the donor before the due date, including extensions, of the return on which a deduction is first claimed, or reported in the case of a donor that is a partnership or S corporation, under section 170 with respect to the donated property, or, in the case of a deduction first claimed, or reported, on an amended return, the date on which the return is filed.

(9) *Prohibited appraisal fees.* The fee for a qualified appraisal cannot be based to any extent on the appraised value of the property. For example, a fee for an appraisal will be treated as based on the appraised value of the property if any part of the fee depends on the amount of the appraised value that is allowed by the Internal Revenue Service after an examination.

(10) *Retention of qualified appraisal.* The donor must retain the qualified appraisal for so long as it may be relevant in the administration of any internal revenue law.

(11) *Effect of appraisal disregarded pursuant to 31 U.S.C. 330(c).* If an appraiser has been prohibited from practicing before the Internal Revenue Service by the Secretary under 31 U.S.C. 330(c) at any time during the three-year period ending on the date the appraisal is signed by the appraiser, any appraisal prepared by the appraiser will be disregarded as to value, but could constitute a qualified appraisal if the requirements of this section are otherwise satisfied, and the donor had no knowledge that the signature, date, or declaration was false when the appraisal and Form 8283 (Section B) were signed by the appraiser.

(12) *Partial interest.* If the contributed property is a partial interest, the appraisal must be of the partial interest.

(b) *Qualified appraiser*—(1) *Definition.* For purposes of section 170(f)(11) and §1.170A–16(d)(1)(ii) and (e)(1)(ii), the term *qualified appraiser* means an individual with verifiable education and experience in valuing the type of property for which the appraisal is performed, as described in paragraphs (b)(2) through (4) of this section.

(2) *Education and experience in valuing the type of property*—(i) *In general.* An individual is treated as having education and experience in valuing the type of property within the meaning of paragraph (b)(1) of this section if, as of the date the individual signs the appraisal, the individual has—

(A) Successfully completed (for example, received a passing grade on a final examination) professional or college-level coursework, as described in paragraph (b)(2)(ii) of this section, in valuing the type of property, as described in paragraph (b)(3) of this section, and has two or more years of experience in valuing the type of property, as described in paragraph (b)(3) of this section; or

(B) Earned a recognized appraiser designation, as described in paragraph (b)(2)(iii) of this section, for the type of property, as described in paragraph (b)(3) of this section.

(ii) *Coursework must be obtained from an educational organization, generally recognized professional trade or appraiser organization, or employer educational program.* For purposes of paragraph (b)(2)(i)(A) of this section, the coursework must be obtained from—

(A) A professional or college-level educational organization described in section 170(b)(1)(A)(ii);

(B) A generally recognized professional trade or appraiser organization that regularly offers educational programs in valuing the type of property; or

(C) An employer as part of an employee apprenticeship or educational program substantially similar to the educational programs described in paragraphs (b)(2)(ii)(A) and (B) of this section.

(iii) *Recognized appraiser designation defined.* A *recognized appraiser designation* means a designation awarded by a generally recognized professional appraiser organization on the basis of demonstrated competency.

(3) *Type of property defined*—(i) *In general.* The type of property means the category of property customary in the appraisal field for an appraiser to value.

(ii) *Examples.* The following examples illustrate the rule of paragraphs (b)(2)(i) and (b)(3)(i) of this section:

Example (1). Coursework in valuing type of property. There are very few professional-level courses offered in widget appraising, and it is customary in the appraisal field for personal property appraisers to appraise widgets. Appraiser *A* has successfully completed professional-level coursework in valuing personal property generally but has completed no coursework in valuing widgets. The coursework completed by Appraiser *A* is for the type of property under paragraphs (b)(2)(i) and (b)(3)(i) of this section.

Example (2). Experience in valuing type of property. It is customary for professional antique appraisers to appraise antique widgets. Appraiser *B* has 2 years of experience in valuing antiques generally and is asked to appraise an antique widget. Appraiser *B* has obtained experience in valuing the type of property under paragraphs (b)(2)(i) and (b)(3)(i) of this section.

Example (3). No experience in valuing type of property. It is not customary for professional antique appraisers to appraise new widgets. Appraiser *C* has experience in appraising antiques generally but no experience in appraising new widgets. Appraiser *C* is asked to appraise a new widget. Appraiser *C* does not have experience in valuing the type of property under paragraphs (b)(2)(i) and (b)(3)(i) of this section.

(4) *Verifiable.* For purposes of paragraph (b)(1) of this section, education and experience in valuing the type of property are verifiable if the appraiser specifies in the appraisal the appraiser's education and experience in valuing the type of property, as described in paragraphs (b)(2) and (3) of this section, and the appraiser makes a declaration in the appraisal that, because of the appraiser's education and experience, the appraiser is qualified to make appraisals of the type of property being valued.

(5) *Individuals who are not qualified appraisers.* The following individuals are not qualified appraisers for the appraised property:

(i) An individual who receives a fee prohibited by paragraph (a)(9) of this section for the appraisal of the appraised property.

(ii) The donor of the property.

(iii) A party to the transaction in which the donor acquired the property (for example, the individual who sold, exchanged, or gave the property to the donor, or any individual who acted as an agent for the transferor or for the donor for the sale, exchange, or gift), unless the property is contributed within 2 months of the date of acquisition and its appraised value does not exceed its acquisition price.

(iv) The donee of the property.

(v) Any individual who is either—

(A) Related, within the meaning of section 267(b), to, or an employee of, an individual described in paragraph (b)(5)(ii), (iii), or (iv) of this section;

(B) Married to an individual described in paragraph (b)(5)(v)(A) of this section; or

(C) An independent contractor who is regularly used as an appraiser by any of the individuals described in paragraph (b)(5)(ii), (iii), or (iv) of this section, and who does not perform a majority of his or her appraisals for others during the taxable year.

(vi) An individual who is prohibited from practicing before the Internal Revenue Service by the Secretary under 31 U.S.C. 330(c) at any time during the three-year period ending on the date the appraisal is signed by the individual.

(c) *Effective/applicability date.* This section applies to contributions made on or after January 1, 2019. Taxpayers may rely on the rules of this section for appraisals prepared for returns or submissions filed after August 17, 2006.

[T.D. 9836, 83 FR 36425, July 30, 2018]

§ 1.170A–18 Contributions of clothing and household items.

(a) *In general.* Except as provided in paragraph (b) of this section, no deduction is allowed under section 170(a) for a contribution of clothing or a household item (as described in paragraph (c) of this section) unless—

(1) The item is in good used condition or better at the time of the contribution; and

(2) The donor meets the substantiation requirements of § 1.170A–16.

(b) *Certain contributions of clothing or household items with claimed value of more than $500.* The rule described in paragraph (a)(1) of this section does not apply to a contribution of a single item of clothing or a household item for which a deduction of more than $500 is claimed, if the donor submits with the return on which the deduction is claimed a qualified appraisal, as defined in § 1.170A–17(a)(1), of the property prepared by a qualified appraiser, as defined in § 1.170A–17(b)(1), and a completed Form 8283 (Section B), ''Noncash Charitable Contributions,'' as described in § 1.170A–16(d)(3).

(c) *Definition of household items.* For purposes of section 170(f)(16) and this section, the term *household items* includes furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry, gems, and collections are not household items.

(d) *Effective/applicability date.* This section applies to contributions made after July 30, 2018. Taxpayers may rely on the rules of this section for contributions made after August 17, 2006.

[T.D. 9836, 83 FR 36427, July 30, 2018]

§ 1.171–1 Bond premium.

(a) *Overview*—(1) *In general.* This section and §§ 1.171–2 through 1.171–5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond premium is intended to generally conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§ 1.171–2 through 1.171–5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section and §§ 1.171–2 through 1.171–5 apply in a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275–2(g) applies for purposes of this section and §§ 1.171–2 through 1.171–5.

(2) *Cross-references.* For rules dealing with the adjustments to a holder's basis to reflect the amortization of bond premium, see § 1.1016–5(b). For rules dealing with the treatment of bond issuance premium by an issuer, see § 1.163–13.

(b) *Scope*—(1) *In general.* Except as provided in paragraph (b)(2) of this section and § 1.171–5, this section and §§ 1.171–2 through 1.171–4 apply to any bond that, upon its acquisition by the holder, is held with bond premium. For purposes of this section and §§ 1.171–2 through 1.171–5, the term *bond* has the same meaning as the term *debt instrument* in § 1.1275–1(d).

(2) *Exceptions.* This section and §§ 1.171–2 through 1.171–5 do not apply to—

(i) A bond described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration);

(ii) A bond to which § 1.1275–4 applies (relating to certain debt instruments that provide for contingent payments);

(iii) A bond held by a holder that has made a § 1.1272–3 election with respect to the bond;

(iv) A bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the ordinary course of the holder's trade or business; or

(v) A bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.

(c) *General rule*—(1) *Tax-exempt obligations.* A holder must amortize bond premium on a bond that is a tax-exempt obligation. See § 1.171–2(c) *Example 4*.

(2) *Taxable bonds.* A holder may elect to amortize bond premium on a taxable bond. Except as provided in paragraph (c)(3) of this section, a taxable bond is any bond other than a tax-exempt obligation. See § 1.171–4 for rules relating to the election to amortize bond premium on a taxable bond.

(3) *Bonds the interest on which is partially excludable.* For purposes of this section and §§ 1.171–2 through 1.171–5, a bond the interest on which is partially excludable from gross income is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's basis in the bond and each payment on the bond are allocated between the two instruments based on a reasonable method.

(d) *Determination of bond premium*—(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest). This excess is bond premium, which is amortizable under § 1.171–2.

(2) *Additional rules for amounts payable on certain bonds.* Additional rules apply to determine the amounts payable on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See § 1.171–3.

(e) *Basis.* A holder determines its basis in a bond under this paragraph (e). This determination of basis applies only for purposes of this section and §§ 1.171–2 through 1.171–5. Because of the application of this paragraph (e), the holder's basis in the bond for purposes of these sections may differ from the holder's basis for determining gain or loss on the sale or exchange of the bond.

(1) *Determination of basis*—(i) *In general.* In general, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond.

(ii) *Bonds acquired in certain exchanges.* If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) *Example 1* of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

(iii) *Convertible bonds*—(A) *General rule.* If the bond is a convertible bond, the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options. See paragraph (f) *Example 2* of this section.

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction described in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

(C) *Definition of convertible bond.* A convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt. For bonds issued on or after February 5, 2013, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

(2) *Basis in bonds held by certain transferees.* Notwithstanding paragraph (e)(1) of this section, if the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a premium, the holder's basis in the bond is—

(i) The holder's basis for determining loss on the sale or exchange of the bond; reduced by

(ii) Any amounts that the transferor could not have amortized under this paragraph (e) or under §1.171–4(c), except to the extent that the holder's basis already reflects a reduction attributable to such nonamortizable amounts.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1. Bond received in liquidation of a partnership interest. (i) *Facts.* PR is a partner in partnership PRS. PRS does not have any unrealized receivables or inventory items as defined in section 751. On January 1, 1998, PRS distributes to PR a taxable bond, issued by an unrelated corporation, in liquidation of PR's partnership interest. At that time, the fair market value of PR's partnership interest is $40,000 and the basis is $100,000. The fair market value of the bond is $40,000.

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for determining loss on the sale or exchange of the bond is $100,000. However, because the distribution is treated as an exchange for purposes of section 171(b)(4), PR's basis in the bond is $40,000 for purposes of this section and §§1.171–2 through 1.171–5. See paragraph (e)(1)(ii) of this section.

Example 2. Convertible bond. (i) *Facts.* On January 1, A purchases for $1,100 B corporation's bond maturing in three years from the purchase date, with a stated principal amount of $1,000, payable at maturity. The bond provides for unconditional payments of interest of $30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On the purchase date, B corporation's nonconvertible, publicly-traded, three-year debt of comparable credit quality trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is $1,100. As of the purchase date, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of $980. Thus, the value of the conversion option is $120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is $980 ($1,100 − $120) for purposes of this section and §§1.171–2 through 1.171–5. The sum of all amounts payable on the bond other than qualified stated interest is $1,000. Because A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed $1,000, A does not acquire the bond at a premium.

(iii) *Applicability date.* Notwithstanding §1.171–5(a)(1), this *Example 2* applies to bonds acquired on or after July 6, 2011.

[T.D. 8746, 62 FR 68177, Dec. 31, 1997, as amended by T.D. 9533, 76 FR 39280, July 6, 2011; T.D. 9612, 78 FR 8005, Feb. 5, 2013; T.D. 9637, 78 FR 54759, Sept. 6, 2013]

§ 1.171–2 Amortization of bond premium.

(a) *Offsetting qualified stated interest with premium*—(1) *In general.* A holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See §1.446–2(b) to determine the accrual period to which qualified stated interest is allocable

and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond premium allocable to an accrual period.* The bond premium allocable to an accrual period is determined under this paragraph (a)(3). Within an accrual period, the bond premium allocable to the period accrues ratably.

(i) *Step one: Determine the holder's yield.* The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the bond as determined under §1.171–1(e). For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

(ii) *Step two: Determine the accrual periods.* A holder determines the accrual periods for the bond under the rules of §1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond premium allocable to the accrual period.* The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's adjusted acquisition price (as defined in paragraph (b) of this section) at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272–1(b)(4) apply in determining the bond premium allocable to an accrual period.

(4) *Bond premium in excess of qualified stated interest*—(i) *Taxable bonds*—(A) *Bond premium deduction.* In the case of a taxable bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated by the holder as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods. A deduction determined under this paragraph (a)(4)(i)(A) is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions). See *Example 1* of §1.171–3(e).

(B) *Carryforward.* If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period under paragraph (a)(4)(i)(A) of this section, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.

(C) *Carryforward in holder's final accrual period*—(*1*) *Bond premium deduction.* If there is a bond premium carryforward determined under paragraph (a)(4)(i)(B) of this section as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of, the holder treats the amount of the carryforward as a bond premium deduction under section 171(a)(1) for the holder's taxable year in which the sale, retirement, or other disposition occurs. For purposes of §1.1016–5(b), the holder's basis in the bond is reduced by the amount of bond premium allowed as a deduction under this paragraph (a)(4)(i)(C)(*1*).

(*2*) *Effective/applicability date.* Notwithstanding §1.171–5(a)(1), paragraph (a)(4)(i)(C)(*1*) of this section applies to a bond acquired on or after January 4, 2013. A taxpayer, however, may rely on paragraph (a)(4)(i)(C)(*1*) of this section for a bond acquired before that date.

(ii) *Tax-exempt obligations.* In the case of a tax-exempt obligation, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss. If a regulated investment company (RIC) within the meaning of section 851 has excess bond premium for an accrual period that would be a nondeductible loss under the prior sentence, the RIC must use this excess bond premium to reduce its tax-exempt interest income on other tax-exempt obligations held during the accrual period.

(5) *Additional rules for certain bonds.* Additional rules apply to determine the amortization of bond premium on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See §1.171–3.

(b) *Adjusted acquisition price.* The adjusted acquisition price of a bond at the beginning of the first accrual period is the holder's basis as determined under §1.171–1(e). Thereafter, the adjusted acquisition price is the holder's basis in the bond decreased by—

(1) The amount of bond premium previously allocable under paragraph (a)(3) of this section; and

(2) The amount of any payment previously made on the bond other than a payment of qualified stated interest.

(c) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Taxable bond. (i) *Facts.* On February 1, 1999, A purchases for $110,000 a taxable bond maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on February 1 of each year. A uses the cash receipts and disbursements method of accounting, and A decides to use annual accrual periods ending on February 1 of each year.

(ii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under §1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 8.07 percent, compounded annually. The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield (8.07 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $1,118.17 ($10,000 − $8,881.83).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). Under §1.1016–5(b), A's basis in the bond is reduced by $1,118.17 on February 1, 2000.

Example 2. Alternative accrual periods. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A decides to use semiannual accrual periods ending on February 1 and August 1 of each year.

(ii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the bond and A's basis in the bond, A's yield is 7.92 percent, compounded semiannually. The bond premium allocable to the accrual period ending on August 1, 1999, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $645.29 ($5,000 − $4,354.71). Although the accrual period ends on August 1, 1999, the qualified stated interest of $5,000 is not taken into income until February 1, 2000, the date it is received. Likewise, the bond premium of $645.29 is not taken into account until February 1, 2000. The adjusted acquisition price of the bond on August 1, 1999, is $109,354.71 (the adjusted acquisition price at the beginning of the period ($110,000) less the bond premium allocable to the period ($645.29)).

(iii) *Bond premium allocable to the second accrual period.* Because the interval between payments of qualified stated interest contains more than one accrual period, the adjusted acquisition price at the beginning of the second accrual period must be adjusted for the accrued but unpaid qualified stated interest. See paragraph (a)(3)(iii) of this section and §1.1272–1(b)(4)(i)(B). Therefore, the adjusted acquisition price on August 1, 1999, is $114,354.71 ($109,354.71 + $5,000). The bond premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($5,000) over the product of the adjusted acquisition price at the beginning of the period ($114,354.71) and A's yield, stated appropriately taking into account the length of the accrual period (7.92 percent/2). Therefore, the bond premium allocable to the accrual period is $472.88 ($5,000 − $4,527.12).

(iv) *Premium used to offset interest.* Although A receives an interest payment of $10,000 on February 1, 2000, A only includes in income $8,881.83, the qualified stated interest of $10,000 ($5,000 allocable to the accrual period ending on August 1, 1999, and $5,000 allocable to the accrual period ending on February 1, 2000) offset with bond premium of $1,118.17 ($645.29 allocable to the accrual period ending on August 1, 1999, and $472.88 allocable to the accrual period ending on February 1, 2000). As indicated in *Example 1* of this paragraph (c), this same amount would be taken into income at the same time had A used annual accrual periods.

Example 3. Holder uses accrual method of accounting. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c) except that A uses an accrual method of accounting. Thus, for the accrual period ending on February 1, 2000, the qualified stated interest allocable to the period is $10,000, and the bond premium allocable to the period is $1,118.17. Because the accrual period extends beyond the end of A's taxable year, A must allocate these amounts between the two taxable years.

(ii) *Amounts allocable to the first taxable year.* The qualified stated interest allocable to the first taxable year is $9,166.67 ($10,000 × 11⁄12). The bond premium allocable to the first taxable year is $1,024.99 ($1,118.17 × 11⁄12).

(iii) *Premium used to offset interest.* For 1999, A includes in income $8,141.68, the qualified stated interest allocable to the period ($9,166.67) offset with bond premium allocable to the period ($1,024.99). Under §1.1016–5(b), A's basis in the bond is reduced by $1,024.99 in 1999.

(iv) *Amounts allocable to the next taxable year.* The remaining amounts of qualified stated interest and bond premium allocable to the accrual period ending on February 1, 2000, are taken into account for the taxable year ending on December 31, 2000.

Example 4. Tax-exempt obligation. (i) *Facts.* On January 15, 1999, C purchases for $120,000 a tax-exempt obligation maturing on January 15, 2006, with a stated principal amount of $100,000, payable at maturity. The obligation provides for unconditional payments of interest of $9,000, payable on January 15 of each year. C uses the cash receipts and disbursements method of accounting, and C decides to use annual accrual periods ending on January 15 of each year.

(ii) *Amount of bond premium.* The interest payments on the obligation are qualified stated interest. Therefore, the sum of all amounts payable on the obligation (other than the interest payments) is $100,000. Under §1.171–1, the amount of bond premium is $20,000 ($120,000—$100,000).

(iii) *Bond premium allocable to the first accrual period.* Based on the remaining payment schedule of the obligation and C's basis in the obligation, C's yield is 5.48 percent, compounded annually. The bond premium allocable to the accrual period ending on January 15, 2000, is the excess of the qualified stated interest allocable to the period ($9,000) over the product of the adjusted acquisition price at the beginning of the period ($120,000) and C's yield (5.48 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $2,420.55 ($9,000 − $6,579.45).

(iv) *Premium used to offset interest.* Although C receives an interest payment of $9,000 on January 15, 2000, C only receives tax-exempt interest income of $6,579.45, the qualified stated interest allocable to the period ($9,000) offset with bond premium allocable to the period ($2,420.55). Under §1.1016–5(b), C's basis in the obligation is reduced by $2,420.55 on January 15, 2000.

[T.D. 8746, 62 FR 68178, Dec. 31, 1997, as amended by T.D. 9653, 79 FR 2590, Jan. 15, 2014]

§ 1.171–3 Special rules for certain bonds.

(a) *Variable rate debt instruments.* A holder determines bond premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The holder also allocates any bond premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The holder constructs the equivalent fixed rate debt instrument, as of the date the holder acquires the variable rate debt instrument, by using the principles of §1.1275–5(e). See paragraph (e) *Example 1* of this section.

(b) *Inflation-indexed debt instruments.* A holder determines bond premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the remaining term of the instrument. The holder also allocates any bond premium among the accrual periods by assuming that there will be no inflation or deflation over the remaining term of the instrument. The bond premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding §1.171–2(a)(4), if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275–7(f)(1)(i). However, the rules in §1.171–2(a)(4)(i)(C) apply to any remaining deflation adjustment attributable to bond premium as of the end of the holder's accrual period in which the bond is sold, retired, or otherwise disposed of. See §1.1275–7 for other rules relating to inflation-indexed debt instruments.

(c) *Yield and remaining payment schedule of certain bonds subject to contingencies*—(1) *Applicability*. This paragraph (c) provides rules that apply in determining the yield and remaining payment schedule of certain bonds that provide for an alternative payment schedule (or schedules) applicable upon the occurrence of a contingency (or contingencies). This paragraph (c) applies, however, only if the timing and amounts of the payments that comprise each payment schedule are known as of the date the holder acquires the bond (the acquisition date) and the bond is subject to paragraph (c)(2), (3), or (4) of this section. A bond does not provide for an alternative payment schedule merely because there is a possibility of impairment of a payment (or payments) by insolvency, default, or similar circumstances. See §1.1275–4 for the treatment of a bond that provides for a contingency that is not described in this paragraph (c).

(2) *Remaining payment schedule that is significantly more likely than not to occur*. If, based on all the facts and circumstances as of the acquisition date, a single remaining payment schedule for a bond is significantly more likely than not to occur, this remaining payment schedule is used to determine and amortize bond premium under §§1.171–1 and 1.171–2.

(3) *Mandatory sinking fund provision*. Notwithstanding paragraph (c)(2) of this section, if a bond is subject to a mandatory sinking fund provision described in §1.1272–1(c)(3), the provision is ignored for purposes of determining and amortizing bond premium under §§1.171–1 and 1.171–2.

(4) *Treatment of certain options*—(i) *Applicability*. Notwithstanding paragraphs (c)(2) and (3) of this section, the rules of this paragraph (c)(4) determine the remaining payment schedule of a bond that provides the holder or issuer with an unconditional option or options, exercisable on one or more dates during the remaining term of the bond, to alter the bond's remaining payment schedule.

(ii) *Operating rules*. A holder determines the remaining payment schedule of a bond by assuming that each option will (or will not) be exercised under the following rules:

(A) *Issuer options*. In general, the issuer is deemed to exercise or not exercise an option or combination of options in the manner that minimizes the holder's yield on the obligation. However, the issuer of a taxable bond is deemed to exercise or not exercise a call option or combination of call options in the manner that maximizes the holder's yield on the bond.

(B) *Holder options*. A holder is deemed to exercise or not exercise an option or combination of options in the manner that maximizes the holder's yield on the bond.

(C) *Multiple options*. If both the issuer and the holder have options, the rules of paragraphs (c)(4)(ii)(A) and (B) of this section are applied to the options in the order that they may be exercised. Thus, the deemed exercise of one option may eliminate other options that are later in time.

(5) *Subsequent adjustments*—(i) *In general*. Except as provided in paragraph (c)(5)(ii) of this section, if a contingency described in this paragraph (c) (including the exercise of an option described in paragraph (c)(4) of this section) actually occurs or does not occur, contrary to the assumption made pursuant to paragraph (c) of this section (a change in circumstances), then solely for purposes of section 171, the bond is treated as retired and reacquired by the holder on the date of the change in circumstances for an amount equal to the adjusted acquisition price of the bond as of that date. If, however, the change in circumstances results in a substantially contemporaneous pro-rata prepayment as defined in §1.1275–2(f)(2), the pro-rata prepayment is treated as a payment in retirement of a portion of the bond. See paragraph (e) *Example 2* of this section.

(ii) *Bond premium deduction on the issuer's call of a taxable bond*. If a change in circumstances results from an issuer's call of a taxable bond or a partial call that is a pro-rata prepayment, the holder may deduct as bond premium an amount equal to the excess, if any, of the holder's adjusted acquisition price of the bond over the greater of—

(A) The amount received on redemption; and

(B) The amounts that would have been payable under the bond (other than payments of qualified stated interest) if no change in circumstances had occurred.

(d) *Remote and incidental contingencies.* For purposes of determining and amortizing bond premium, if a bond provides for a contingency that is remote or incidental (within the meaning of §1.1275–2(h)), the holder takes the contingency into account under the rules for remote and incidental contingencies in §1.1275–2(h).

(e) *Examples.* The following examples illustrate the rules of this section. Each example assumes the holder uses the calendar year as its taxable year and has elected to amortize bond premium, effective for all relevant taxable years. In addition, each example assumes a 30-day month and 360-day year. Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention. The examples are as follows:

Example 1. Variable rate debt instrument. (i) *Facts.* On March 1, 1999, E purchases for $110,000 a taxable bond maturing on March 1, 2007, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest on March 1 of each year based on the percentage appreciation of a nationally-known commodity index. On March 1, 1999, it is reasonably expected that the bond will yield 12 percent, compounded annually. E uses the cash receipts and disbursements method of accounting, and E decides to use annual accrual periods ending on March 1 of each year. Assume that the bond is a variable rate debt instrument under §1.1275–5.

(ii) *Amount of bond premium.* Because the bond is a variable rate debt instrument, E determines and amortizes its bond premium by reference to the equivalent fixed rate debt instrument constructed for the bond as of March 1, 1999. Because the bond provides for interest at a single objective rate that is reasonably expected to yield 12 percent, compounded annually, the equivalent fixed rate debt instrument for the bond is an eight-year bond with a principal amount of $100,000, payable at maturity. It provides for annual payments of interest of $12,000. E's basis in the equivalent fixed rate debt instrument is $110,000. The sum of all amounts payable on the equivalent fixed rate debt instrument (other than payments of qualified stated interest) is $100,000. Under §1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iii) *Bond premium allocable to each accrual period.* E allocates bond premium to the remaining accrual periods by reference to the payment schedule on the equivalent fixed rate debt instrument. Based on the payment schedule of the equivalent fixed rate debt instrument and E's basis in the bond, E's yield is 10.12 percent, compounded annually. The bond premium allocable to the accrual period ending on March 1, 2000, is the excess of the qualified stated interest allocable to the period for the equivalent fixed rate debt instrument ($12,000) over the product of the adjusted acquisition price at the beginning of the period ($110,000) and E's yield (10.12 percent, compounded annually). Therefore, the bond premium allocable to the accrual period is $870.71 ($12,000 − $11,129.29). The bond premium allocable to all the accrual periods is listed in the following schedule:

Accrual period ending	Adjusted acquisition price at beginning of accrual period	Premium allocable to accrual period
3/1/00	$110,000.00	$870.71
3/1/01	109,129.29	958.81
3/1/02	108,170.48	1,055.82
3/1/03	107,114.66	1,162.64
3/1/04	105,952.02	1,280.27
3/1/05	104,671.75	1,409.80
3/1/06	103,261.95	1,552.44
3/1/07	101,709.51	1,709.51
		10,000.00

(iv) *Qualified stated interest for each accrual period.* Assume the bond actually pays the following amounts of qualified stated interest:

Accrual period ending	Qualified stated interest
3/1/00	$2,000.00
3/1/01	0.00
3/1/02	0.00
3/1/03	10,000.00
3/1/04	8,000.00
3/1/05	12,000.00
3/1/06	15,000.00
3/1/07	8,500.00

(v) *Premium used to offset interest.* E's interest income for each accrual period is determined by offsetting the qualified stated interest allocable to the period with the bond premium allocable to the period. For the accrual period ending on March 1, 2000, E includes in income $1,129.29, the qualified stated interest allocable to the period ($2,000) offset with the bond premium allocable to the period ($870.71). For the accrual period ending on March 1, 2001, the bond premium allocable to the accrual period ($958.81) exceeds the qualified stated interest allocable to the period ($0) and, therefore, E does not have interest income for this accrual period. However, under § 1.171–2(a)(4)(i)(A), E may deduct as bond premium $958.81, the excess of the bond premium allocable to the accrual period ($958.81) over the qualified stated interest allocable to the accrual period ($0). For the accrual period ending on March 1, 2002, the bond premium allocable to the accrual period ($1,055.82) exceeds the qualified stated interest allocable to the accrual period ($0) and, therefore, E does not have interest income for the accrual period. Under § 1.171–2(a)(4)(i)(A), E's deduction for bond premium for the accrual period is limited to $170.48, the excess of E's total interest inclusions on the bond in prior accrual periods ($1,129.29) over the total amount treated by E as a bond premium deduction in prior accrual periods ($958.81). Under § 1.171–2(a)(4)(i)(B), E must carry forward the remaining $885.34 of bond premium allocable to the period ending March 1, 2002, and treat it as bond premium allocable to the period ending March 1, 2003. The amount E includes in income for each accrual period is shown in the following schedule:

Accrual period ending	Qualified stated interest	Premium allocable to accrual period	Interest income	Premium deduction	Premium carryforward
3/1/00	$2,000.00	$870.71	$1,129.29		
3/1/01	0.00	958.81	0.00	$958.81	
3/1/02	0.00	1,055.82	0.00	170.48	$885.34
3/1/03	10,000.00	1,162.64	7,951.93		
3/1/04	8,000.00	1,280.27	6,719.73		
3/1/05	12,000.00	1,409.80	10,590.20		
3/1/06	15,000.00	1,552.44	13,447.56		
3/1/07	8,500.00	1,709.51	6,790.49		
		10,000.00			

Example 2. Partial call that results in a prorata prepayment. (i) *Facts.* On April 1, 1999, M purchases for $110,000 N's taxable bond maturing on April 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $10,000, payable on April 1 of each year. N has the option to call all or part of the bond on April 1, 2001, at a 5 percent premium over the principal amount. M uses the cash receipts and disbursements method of accounting.

(ii) *Determination of yield and the remaining payment schedule.* M's yield determined without regard to the call option is 8.07 percent, compounded annually. M's yield determined by assuming N exercises its call option is 6.89 percent, compounded annually. Under paragraph (c)(4)(ii)(A) of this section, it is assumed N will not exercise the call option because exercising the option would minimize M's yield. Thus, for purposes of determining and amortizing bond premium, the bond is assumed to be a seven-year bond with a single principal payment at maturity of $100,000.

(iii) *Amount of bond premium.* The interest payments on the bond are qualified stated interest. Therefore, the sum of all amounts payable on the bond (other than the interest payments) is $100,000. Under § 1.171–1, the amount of bond premium is $10,000 ($110,000 − $100,000).

(iv) *Bond premium allocable to the first two accrual periods.* For the accrual period ending on April 1, 2000, M includes in income $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,118.17). The adjusted acquisition price on April 1, 2000, is $108,881.83 ($110,000 − $1,118.17). For the accrual period ending on April 1, 2001, M includes in income $8,791.54, the qualified stated interest allocable to the period ($10,000) offset with bond premium allocable to the period ($1,208.46). The adjusted acquisition price on April 1, 2001, is $107,673.37 ($108,881.83 − $1,208.46).

(v) *Partial call.* Assume N calls one-half of M's bond for $52,500 on April 1, 2001. Because it was assumed the call would not be exercised, the call is a change in circumstances. However, the partial call is also a pro-rata prepayment within the meaning of § 1.1275–2(f)(2). As a result, the call is treated as a retirement of one-half of the bond. Under paragraph (c)(5)(ii) of this section, M may deduct $1,336.68, the excess of its adjusted acquisition price in the retired portion of the bond ($107,673.37/2, or $53,836.68) over the amount received on redemption ($52,500). M's adjusted basis in the portion of the bond that remains outstanding is $53,836.68 ($107,673.37 − $53,836.68).

[T.D. 8746, 62 FR 68180, Dec. 31, 1997, as amended by T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9609, 78 FR 668, Jan. 4, 2013; T.D. 9653, 79 FR 2591, Jan. 15, 2014]

§ 1.171–4 Election to amortize bond premium on taxable bonds.

(a) *Time and manner of making the election*—(1) *In general.* A holder makes the election to amortize bond premium by offsetting interest income with bond premium in the holder's timely filed federal income tax return for the first taxable year to which the holder desires the election to apply. The holder should attach to the return a statement that the holder is making the election under this section.

(2) *Coordination with OID election.* If a holder makes an election under § 1.1272–3 for a bond with bond premium, the holder is deemed to have made the election under this section.

(b) *Scope of election.* The election under this section applies to all taxable bonds held during or after the taxable year for which the election is made.

(c) *Election to amortize made in a subsequent taxable year*—(1) *In general.* If a holder elects to amortize bond premium and holds a taxable bond acquired before the taxable year for which the election is made, the holder may not amortize amounts that would have been amortized in prior taxable years had an election been in effect for those prior years.

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

Example. (i) *Facts.* On May 1, 1999, C purchases for $130,000 a taxable bond maturing on May 1, 2006, with a stated principal amount of $100,000, payable at maturity. The bond provides for unconditional payments of interest of $15,000, payable on May 1 of each year. C uses the cash receipts and disbursements method of accounting and the calendar year as its taxable year. C has not previously elected to amortize bond premium, but does so for 2002.

(ii) *Amount to amortize.* C's basis for determining loss on the sale or exchange of the bond is $130,000. Thus, under § 1.171–1, the amount of bond premium is $30,000. Under § 1.171–2, if a bond premium election were in effect for the prior taxable years, C would have amortized $3,257.44 of bond premium on May 1, 2000, and $3,551.68 of bond premium on May 1, 2001, based on annual accrual periods ending on May 1. Thus, for 2002 and future years to which the election applies, C may amortize only $23,190.88 ($30,000 − $3,257.44 − $3,551.68).

(d) *Revocation of election.* The election under this section may not be revoked unless approved by the Commissioner. Because a revocation of the election is a change in accounting method, a taxpayer must follow the rules under § 1.446–1(e)(3)(i) to request the Commissioner's consent to revoke the election. A revocation of the election applies to all taxable bonds held during or after the taxable year for which the revocation is effective. The holder may not amortize any remaining bond premium on bonds held at the beginning of the taxable year for which the revocation is effective. Therefore, no adjustment under section 481 is allowed upon the revocation of the election because no items of income or deduction are omitted or duplicated.

[T.D. 8746, 62 FR 68182, Dec. 31, 1997]

§ 1.171–5 Effective date and transition rules.

(a) *Effective date*—(1) *In general.* Sections 1.171–1 through 1.171–4 apply to bonds acquired on or after March 2, 1998. However, if a holder makes the election under § 1.171–4 for the taxable year containing March 2, 1998, or any subsequent taxable year, §§ 1.171–1 through 1.171–4 apply to bonds held on or after the first day of the taxable year in which the election is made.

(2) *Transition rule for use of constant yield.* Notwithstanding paragraph (a)(1) of this section, § 1.171–2(a)(3) (providing that the bond premium allocable to an accrual period is determined with reference to a constant yield) does not apply to a bond issued before September 28, 1985.

(b) *Coordination with existing election.* A holder is deemed to have made the election under § 1.171–4 for the taxable year containing March 2, 1998, if the holder elected to amortize bond premium under section 171 and that election is effective on March 2, 1998. If the holder is deemed to have made the election under § 1.171–4 for the taxable year containing March 2, 1998, §§ 1.171–1 through 1.171–4 apply to bonds acquired on or after the first day of that taxable year. See § 1.171–4(d) for rules relating to a revocation of an election under section 171.

(c) *Accounting method changes*—(1) *Consent to change.* A holder required to change its method of accounting for bond premium to comply with §§ 1.171–1 through 1.171–3 must secure the consent of the Commissioner in accordance with the requirements of § 1.446–1(e). Paragraph (c)(2) of this section provides the Commissioner's automatic consent for certain changes. A holder making the election under § 1.171–4 does not need the Commissioner's consent to make the election.

(2) *Automatic consent.* The Commissioner grants consent for a holder to change its method of accounting for bond premium with respect to taxable bonds to which §§ 1.171–1 through 1.171–3 apply. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (c)(2) applies provided—

(i) The holder elected to amortize bond premium under section 171 for a taxable year prior to the taxable year containing March 2, 1998, and that election has not been revoked;

(ii) The change is made for the first taxable year for which the holder must account for a bond under §§ 1.171–1 through 1.171–3; and

(iii) The holder attaches to its return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 8746, 62 FR 68182, Dec. 31, 1997]

§ 1.172–1 Net operating loss deduction.

(a) *Allowance of deduction.* Section 172(a) allows as a deduction in computing taxable income for any taxable year subject to the Code the aggregate of the net operating loss carryovers and net operating loss carrybacks to such taxable year. This deduction is referred to as the net operating loss deduction. The net operating loss is the basis for the computation of the net operating loss carryovers and net operating loss carrybacks and ultimately for the net operating loss deduction itself. The net operating loss deduction shall not be disallowed for any taxable year merely because the taxpayer has no income from a trade or business for the taxable year.

(b) *Steps in computation of net operating loss deduction.* The three steps to be taken in the ascertainment of the net operating loss deduction for any taxable year subject to the Code are as follows:

(1) Compute the net operating loss for any preceding or succeeding taxable year from which a net operating loss may be carried over or carried back to such taxable year.

(2) Compute the net operating loss carryovers to such taxable year from such preceding taxable years and the net operating loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such net operating loss carryovers and carrybacks in order to determine the net operating loss deduction for such taxable year.

(c) *Statement with tax return.* Every taxpayer claiming a net operating loss deduction for any taxable year shall file with his return for such year a concise statement setting forth the amount of the net operating loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the net operating loss deduction.

(d) *Ascertainment of deduction dependent upon net operating loss carryback.* If the taxpayer is entitled in computing his net operating loss deduction to a carryback which he is not able to ascertain at the time his return is due, he shall compute the net operating loss deduction on his return without regard to such net operating loss carryback. When the taxpayer ascertains the net operating loss carryback, he may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the net operating loss deduction for the taxable year with the inclusion of such carryback; or he may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.* (1) In determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The net operating loss for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the net operating loss deduction.

(3) The amount of the net operating loss deduction which shall be allowed for any taxable year shall be determined under the law applicable to that year.

(f) *Electing small business corporations.* In determining the amount of the net operating loss deduction of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation was an electing small business corporation under subchapter S (section 1371 and following), chapter 1 of the Code. In applying section 172(b)(1) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation. See section 1374 and the regulations thereunder for allowance of a deduction to shareholders for a net operating loss sustained by an electing small business corporation.

(g) *Husband and wife.* The net operating loss deduction of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of §1.172–7.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§1.172–2 Net operating loss in case of a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a corporation in any taxable year if and to the extent that, for such year, there is an excess of deductions allowed by chapter 1 of the Code over gross income computed thereunder. In determining the excess of deductions over gross income for such purpose—

(1) *Items not deductible.* No deduction shall be allowed under—

(i) Section 172 for the net operating loss deduction, and

(ii) Section 922 in respect of Western Hemisphere trade corporations;

(2) *Dividends received.* The 85-percent limitation provided by section 246(b) shall not apply to the deductions otherwise allowed under—

(i) Section 243(a) in respect of dividends received from domestic corporations.

(ii) Section 244 in respect of dividends received on preferred stock of public utilities, and

(iii) Section 245 in respect of dividends received from foreign corporations; and

(3) *Dividends paid.* The deduction granted by section 247 in respect of dividends paid on the preferred stock of public utilities shall be computed without regard to subsection (a)(1)(B) of Section 247.

(b) *Example.* The following example illustrates the application of paragraph (a):

Example. For the calendar year 1981, the X corporation has a gross income of $400,000 and total deductions allowed by chapter 1 of the Code of $375,000 exclusive of any net operating loss deduction and exclusive of any deduction for dividends received or paid. Corporation X in 1981 received $100,000 of dividends entitled to the benefits of section 243(a). These dividends are included in Corporation X's $400,000 gross income. Corporation X has no other deductions to which section 172(d) applies. On the basis of these facts, Corporation X has a net operating loss for the year 1981 of $60,000, computed as follows:

Deductions for 1981	$375,000
Plus: Deduction for dividends received, computed without regard to the limitation provided in section 246(b) (85% of $100,000)	85,000
Total	460,000

Less: Gross income for 1981 (including $100,000 dividends)	400,000
Net operating loss for 1981	60,000

(c) *Qualified real estate investment trusts.* For taxable years ending after October 4, 1976, the net operating loss of a qualified real estate investment trust (as defined in § 1.172–10(b)) is computed by taking into account the adjustments described in section 857(b)(2) (other than the deduction for dividends paid, as defined in section 561), as well as the modifications required by paragraph (a)(1) of this section. Thus, for example, the special deductions for dividends received, etc., provided in part VIII of subchapter B (other than section 248), as well as the net operating loss deduction under section 172, are not allowed in computing the net operating loss of a qualified real estate investment trust.

[T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§ 1.172–3 Net operating loss in case of a taxpayer other than a corporation.

(a) *Modification of deductions.* A net operating loss is sustained by a taxpayer other than a corporation in any taxable year if and to the extent that, for such year there is an excess of deductions allowed by chapter 1 of the Internal Revenue Code over gross income computed thereunder. In determining the excess of deductions over gross income for such purpose:

(1) *Items not deductible.* No deduction shall be allowed under:

(i) Section 151 for the personal exemptions or under any other section which grants a deduction in lieu of the deductions allowed by section 151,

(ii) Section 172 for the net operating loss deduction, and

(iii) Section 1202 in respect of the net long-term capital gain.

(2) *Capital losses.* (i) The amount deductible on account of business capital losses shall not exceed the sum of the amount includible on account of business capital gains and that portion of nonbusiness capital gains which is computed in accordance with paragraph (c) of this section.

(ii) The amount deductible on account of nonbusiness capital losses shall not exceed the amount includible on account of nonbusiness capital gains.

(3) *Nonbusiness deductions*—(i) *Ordinary deductions.* Ordinary nonbusiness deductions shall be taken into account without regard to the amount of business deductions and shall be allowed in full to the extent, but not in excess, of that amount which is the sum of the ordinary nonbusiness gross income and the excess of nonbusiness capital gains over nonbusiness capital losses. See paragraph (c) of this section. For purposes of section 172, nonbusiness deductions and income are those deductions and that income which are not attributable to, or derived from, a taxpayer's trade or business. Wages and salary constitute income attributable to the taxpayer's trade or business for such purposes.

(ii) *Sale of business property.* Any gain or loss on the sale or other disposition of property which is used in the taxpayer's trade or business and which is of a character that is subject to the allowance for depreciation provided in section 167, or of real property used in the taxpayer's trade or business, shall be considered, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business. Such gains and losses are to be taken into account fully in computing a net operating loss without regard to the limitation on nonbusiness deductions. Thus, a farmer who sells at a loss land used in the business of farming may, in computing a net operating loss, include in full the deduction otherwise allowable with respect to such loss, without regard to the amount of his nonbusiness income and without regard to whether he is engaged in the trade or business of selling farms. Similarly, an individual who sells at a loss machinery which is used in his trade or business and which is of a character that is subject to the allowance for depreciation may, in computing the net operating loss, include in full the deduction otherwise allowable with respect to such loss.

(iii) *Casualty losses.* Any deduction allowable under section 165(c)(3) for losses of property not connected with a trade or business shall not be considered, for purposes of section 172(d)(4), to be a nonbusiness deduction but shall be treated as a deduction attributable to the taxpayer's trade or business.

(iv) *Self-employed retirement plans.* Any deduction allowed under section 404, relating to contributions of an employer to an employees' trust or annuity plan, or under section 405(c), relating to contributions to a bond purchase plan, to the extent attributable to contributions made on behalf of an individual while he is an employee within the meaning of section 401(c)(1), shall not be treated, for purposes of section 172(d)(4), as attributable to, or derived from, the taxpayer's trade or business, but shall be treated as a nonbusiness deduction.

(v) *Limitation.* The provisions of this subparagraph shall not be construed to permit the deduction of items disallowed by subparagraph (1) of this paragraph.

(b) *Treatment of capital loss carryovers.* Because of the distinction between business and nonbusiness capital gains and losses, a taxpayer who has a capital loss carryover from a preceding taxable year, includible by virtue of section 1212 among the capital losses for the taxable year in issue, is required to determine how much of such capital loss carryover is a business capital loss and how much is a nonbusiness capital loss. In order to make this determination, the taxpayer shall first ascertain what proportion of the net capital loss for such preceding taxable year was attributable to an excess of business capital losses over business capital gains for such year, and what proportion was attributable to an excess of nonbusiness capital losses over nonbusiness capital gains. The same proportion of the capital loss carryover from such preceding taxable year shall be treated as a business capital loss and a nonbusiness capital loss, respectively. In order to determine the composition (business—nonbusiness) of a net capital loss for a taxable year, for purposes of this paragraph, if such net capital loss is computed under paragraph (b) of §1.1212–1 and takes into account a capital loss carryover from a preceding taxable year, the composition (business—nonbusiness) of the net capital loss for such preceding taxable year must also be determined. For purposes of this paragraph, the term *capital loss carryover* means the sum of the short-term and long-term capital loss carryovers from such year. This paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual, has $5,000 ordinary taxable income (computed without regard to the deductions for personal exemptions) for the calendar year 1954 and also has the following capital gains and losses for such year: Business capital gains of $2,000; business capital losses of $3,200; nonbusiness capital gains of $1,000; and nonbusiness capital losses of $1,200.

(ii) A's net capital loss for the taxable year 1954 is $400, computed as follows:

Capital losses	$4,400
Capital gains	3,000
Excess of capital losses over capital gains	1,400
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1954	400

(iii) A's capital losses for 1954 exceeded his capital gains for such year by $1,400. Since A's business capital losses for 1954 exceeded his business capital gains for such year by $1,200, 6/7ths ($1,200/$1,400) of A's net capital loss for 1954 is attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/7th of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the capital loss carryover for 1954 to 1955 is $400, 6/7ths of $400, or $342.86, shall be treated as a business capital loss in 1955; and 1/7th of $400, or $57.14, as a nonbusiness capital loss.

Example 2. (i) A, an individual who is computing a net operating loss for the calendar year 1966, has a capital loss carryover from 1965 of $8,000. In order to apply the provisions of this paragraph, A must determine what portion of the $8,000 carryover is attributable to the excess of business capital losses over business capital gains and what portion thereof is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. For 1965, A had $10,000 ordinary taxable income (computed without regard to the deductions for personal exemptions), and a short-term capital loss carryover of $6,000 from 1964. In order to determine the composition (business—nonbusiness) of the $8,000 carryover from 1965, A first determines that of the $6,000 carryover from 1964, $5,000 is a business capital loss and $1,000 is a nonbusiness capital loss. This must be done since, under paragraph (b) of §1.1212–1, the net capital loss for 1965 is computed by taking into account the capital loss carryover from 1964. A's capital gains and losses for 1965 are as follows:

	1965	Carried over from 1964
Business capital gains	$2,000	0
Business capital losses	3,000	$5,000
Nonbusiness capital gains	4,000	0
Nonbusiness capital losses	6,000	1,000

(ii) A's net capital loss for the taxable year 1965 is $8,000, computed as follows:

Capital losses (including carryovers)	$15,000
Capital gains	6,000
Excess of capital losses over capital gains	9,000
Less: $1,000 of such ordinary taxable income	1,000
Net capital loss for 1965	8,000

(iii) A's capital losses, including carryovers, for 1965 exceeded his capital gains for such year by $9,000. Since A's business capital losses for 1965 exceeded his business capital gains for such year by $6,000, 2/3rds ($6,000/$9,000) of A's net capital loss for 1965 is attributable to an excess of his business capital losses over his business capital gains for such year. Similarly, 1/3rd of the net capital loss is attributable to the excess of nonbusiness capital losses over nonbusiness capital gains. Since the total capital loss carryover from 1965 to 1966 is $8,000, 2/3rds of $8,000, or $5,333.33, shall be treated as a business capital loss in 1966; and 1/3rd of $8,000, or $2,666.67, as a nonbusiness capital loss.

(c) *Determination of portion of nonbusiness capital gains available for the deduction of business capital losses.* In the computation of a net operating loss a taxpayer other than a corporation must use his nonbusiness capital gains for the deduction of his nonbusiness capital losses. Any amount not necessary for this purpose shall then be used for the deduction of any excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income. The remainder, computed by applying the excess ordinary nonbusiness deductions against the excess nonbusiness capital gains, shall be treated as nonbusiness capital gains and used for the purpose of determining the deductibility of business capital losses under paragraph (a)(2)(i) of this section. This principle may be illustrated by the following example:

Example. (1) A, an individual, has a total nonbusiness gross income of $20,500, computed as follows:

Ordinary gross income	$7,500
Capital gains	13,000
Total gross income	20,500

(2) A also has total nonbusiness deductions of $16,000, computed as follows:

Ordinary deductions	$9,000
Capital loss	7,000
Total deductions	16,000

(3) The portion of nonbusiness capital gains to be used for the purpose of determining the deductibility of business capital losses is $4,500, computed as follows:

Nonbusiness capital gains		$13,000
Less: Nonbusiness capital loss		7,000
Excess to be taken into account for purposes of paragraph (a)(3)(i) of this section		6,000
Ordinary nonbusiness deductions	$9,000	
Less: Ordinary nonbusiness gross income	7,500	
		1,500
Portion of nonbusiness capital gains to be used for purposes of paragraph (a)(2)(i) of this section		4,500

(d) *Joint net operating loss of husband and wife.* In the case of a husband and wife, the joint net operating loss for any taxable year for which a joint return is filed is to be computed on the basis of the combined income and deductions of both spouses, and the modifications prescribed in paragraph (a) of this section are to be computed as if the combined income and deductions of both spouses were the income and deductions of one individual.

(e) *Illustration of computation of net operating loss of a taxpayer other than a corporation*—(1) *Facts.* For the calendar year 1954 A, an individual, has gross income of $483,000 and allowable deductions of $540,000. The latter amount does not include the net operating loss deduction or any deduction on account of the sale or exchange of capital assets. Included in gross income are business capital gains of $50,000 and ordinary nonbusiness income of $10,000. Included among the deductions are ordinary nonbusiness deductions of $12,000 and a deduction of $600 for his personal exemption. A has a business capital loss of $60,000 in 1954. A has no other items of income or deductions to which section 172(d) applies.

(2) *Computation.* On the basis of these facts, A has a net operating loss for 1954 of $104,400, computed as follows:

Deductions for 1954 (as specified in first sentence of subparagraph (1))	$540,000
Plus: Amount of business capital loss ($60,000) to extent such amount does not exceed business capital gains ($50,000)	50,000
Total	590,000

Less: Excess of ordinary nonbusiness deductions over ordinary nonbusiness gross income ($12,000 minus $10,000)	$2,000	
Deduction for personal exemption	600	
		$2,600
Deductions for 1954 adjusted as required by section 172(d)		587,400
Gross income for 1954	483,000	
Net operating loss for 1954	104,400	

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6828, 30 FR 7805, June 17, 1965; T.D. 6862, 30 FR 14427, Nov. 18, 1965; T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§ 1.172–4 Net operating loss carrybacks and net operating loss carryovers.

(a) *General provisions*—(1) *Years to which loss may be carried*—(i) *In general.* In order to compute the net operating loss deduction the taxpayer must first determine the part of any net operating losses for any preceding or succeeding taxable years which are carrybacks or carryovers to the taxable year in issue.

(ii) *General rule for carrybacks and carryovers.* Except as provided in section 172 (b)(1)(C), (D), (E), (F), (G), (H), (I), and (J), paragraphs (a)(1)(iii), (iv), (v), and (vi) of this section, and § 1.172–10(a), a net operating loss shall be carried back to the 3 preceding taxable years and carried over to the 15 succeeding taxable years (5 succeeding taxable years for a loss sustained in a taxable year ending before January 1, 1976).

(iii) *Loss of a regulated transportation corporation.* Except as provided in subdivision (iv) of this subparagraph and § 1.172–10(a), a net operating loss sustained by a taxpayer which is a regulated transportation corporation (as defined in section 172(g)(1)) in a taxable year ending before January 1, 1976, shall, subject to the provisions of section 172(g) and § 1.172–8, be carried back to the taxable years specified in paragraph (a)(1)(ii) of this section and shall be carried over to the 7 succeeding taxable years.

(iv) *Loss attributable to foreign expropriation.* If the provisions of section 172(b)(3)(A) and § 1.172–9 are satisfied, the portion of a net operating loss attributable to a foreign expropriation loss (as defined in section 172(h)) shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the 10 taxable years following the taxable year of such loss.

(v) *Loss of a financial institution.* A net operating loss sustained in a taxable year beginning after December 31, 1975, by a taxpayer to which section 585, 586, or 593 applies shall be carried back (except as provided in § 1.172–10(a)) to the 10 preceding taxable years and shall be carried over to the 5 succeeding taxable years.

(vi) *Loss of a Bank for Cooperatives.* A net operating loss sustained by a taxpayer which is a Bank for Cooperatives (organized and chartered pursuant to section 2 of the Farm Credit Act of 1933 (12 U.S.C. 1134)) shall be carried back (except as provided in § 1.172–10(a)) to the 10 preceding taxable years and shall be carried over to the 5 succeeding taxable years.

(2) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 172 the first, second, etc., preceding or succeeding taxable year.

(3) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the net operating loss to the extent it was not absorbed in the computation of the taxable (or net) income for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the taxable (or net) income for any such preceding taxable year, the various net operating loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the taxable (or net) income in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(4) *Husband and wife.* The net operating loss carryovers and carrybacks of a husband and wife shall be determined in accordance with this section, but subject also to the provisions of § 1.172–7.

(5) *Corporate acquisitions.* For the computation of the net operating loss

carryovers in the case of certain acquisitions of the assets of a corporation by another corporation, see section 381 and the regulations thereunder.

(6) *Special limitations.* For special limitations on the net operating loss carryovers in certain cases of change in both the ownership and the trade or business of a corporation and in certain cases of corporate reorganization lacking specified continuity of ownership, see section 382 and the regulations thereunder.

(7) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under Subchapter S (section 1361 and following), chapter 1 of the Code, during one or more of the taxable years described in section 172 (b)(1), see paragraph (f) of § 1.172–1.

(b) *Portion of net operating loss which is a carryback or a carryover to the taxable year in issue.* (1) A net operating loss shall first be carried to the earliest of the several taxable years for which such loss is allowable as a carryback or a carryover, and shall then be carried to the next earliest of such several taxable years, etc. Except as provided in § 1.172–9, the entire net operating loss shall be carried back to such earliest year.

(2) The portion of the loss which shall be carried to any of such several taxable years subsequent to the earliest taxable year is the excess of such net operating loss over the sum of the taxable incomes (computed as provided in § 1.172–5) for all of such several taxable years preceding such subsequent taxable year.

(3) If a portion of the net operating loss for a taxable year is attributable to a foreign expropriation loss (as defined in section 172(h)) and if an election under paragraph (c) of § 1.172–9 is made with respect to such portion of the net operating loss, then see § 1.172–9 for the separate treatment of such portion of the net operating loss.

(c) *Illustration.* The principles of this section are illustrated in § 1.172–6.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43345, Dec. 2, 1986]

§ 1.172–5 Taxable income which is subtracted from net operating loss to determine carryback or carryover.

(a) *Taxable year subject to the Internal Revenue Code of 1954.* The taxable income for any taxable year subject to the Internal Revenue Code of 1954 which is subtracted from the net operating loss for any other taxable year to determine the portion of such net operating loss which is a carryback or a carryover to a particular taxable year is computed with the modifications prescribed in this paragraph. These modifications shall be made independently of, and without reference to, the modifications required by §§ 1.172–2(a) and 1.172–3(a) for purposes of computing the net operating loss itself.

(1) *Modifications applicable to unincorporated taxpayers only.* In the case of a taxpayer other than a corporation, in computing taxable income and adjusted gross income:

(i) No deduction shall be allowed under section 151 for the personal exemptions (or under any other section which grants a deduction in lieu of the deductions allowed by section 151) and under section 1202 in respect of the net long-term capital gain.

(ii) The amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includible on account of gains from sales or exchanges of capital assets.

(2) *Modifications applicable to all taxpayers.* In the case either of a corporation or of a taxpayer other than a corporation:

(i) *Net operating loss deduction.* The net operating loss deduction for such taxable year shall be computed by taking into account only such net operating losses otherwise allowable as carrybacks or carryovers to such taxable year as were sustained in taxable years preceding the taxable year in which the taxpayer sustained the net operating loss from which the taxable income is to be deducted. Thus, for such purposes, the net operating loss for the loss year or any taxable year thereafter shall not be taken into account.

Example. The taxpayer's income tax returns are made on the basis of the calendar year. In computing the net operating loss deduction for 1954, the taxpayer has a carryover from 1952 of $9,000, a carryover from 1953 of $6,000, a carryback from 1955 of $18,000, and a carryback from 1956 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the net operating loss deduction for 1954, for purposes of determining the tax liability for 1954, is $43,000. However, in computing the taxable income for 1954 which is subtracted from the net operating loss for 1955 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $15,000, that is, the aggregate of the $9,000 carryover from 1952 and the $6,000 carryover from 1953. In computing the net operating loss deduction for such purpose, the $18,000 carryback from 1955 and the $10,000 carryback from 1956 are disregarded. In computing the taxable income for 1954, however, which is subtracted from the net operating loss for 1956 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the net operating loss deduction for 1954 is $33,000, that is, the aggregate of the $9,000 carryover from 1952, the $6,000 carryover from 1953, and the $18,000 carryback from 1955. In computing the net operating loss deduction for such purpose, the $10,000 carryback from 1956 is disregarded.

(ii) *Recomputation of percentage limitations.* Unless otherwise specifically provided in this subchapter, any deduction which is limited in amount to a percentage of the taxpayer's taxable income or adjusted gross income shall be recomputed upon the basis of the taxable income or adjusted gross income, as the case may be, determined with the modifications prescribed in this paragraph. Thus, in the case of an individual the deduction for medical expenses would be recomputed after making all the modifications prescribed in this paragraph, whereas the deduction for charitable contributions would be determined without regard to any net operating loss carryback but with regard to any other modifications so prescribed. See, however, the regulations under paragraph (g) of §1.170–2 (relating to charitable contributions carryover of individuals) and paragraph (c) of §1.170–3 (relating to charitable contributions carryover of corporations) for special rules regarding charitable contributions in excess of the percentage limitations which may be treated as paid in succeeding taxable years.

Example 1. For the calendar year 1954 the taxpayer, an individual, files a return showing taxable income of $4,800, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income)	200	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income)	$1,400	
		$2,200
Taxable income		4,800

In 1955 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $3,000. Under section 172(b)(2), it is determined that the entire $3,000 is a carryback to 1954. In 1956 he sustains a net operating loss of $10,000 in the operation of the business. In determining the amount of the carryover of the 1956 loss to 1957, the taxable income for 1954 as computed under this paragraph is $3,970, determined as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction for carryback of 1955 net operating loss		3,000
Adjusted gross income		6,000
Less:		
Deduction for medical expense ($410 actually paid but allowable only to extent in excess of 3 percent of adjusted gross income as modified under this paragraph)	$230	
Deduction for charitable contributions ($2,000 actually paid but allowable only to extent not in excess of 20 percent of adjusted gross income determined with all the modifications prescribed in this paragraph other than the net operating loss carryback)	1,800	
		2,030
Taxable income		3,970

Example 2. For the calendar year 1959 the taxpayer, an individual, files a return showing taxable income of $5,700, computed as follows:

Salary		$5,000
Net long-term capital gain		4,000
Total gross income		9,000
Less: Deduction allowed by section 1202 in respect of net long-term capital gain		2,000
Adjusted gross income		7,000
Less:		
Deduction for personal exemption	$600	
Standard deduction allowed by section 141	$700	
		$1,300
Taxable income		5,700

In 1960 the taxpayer undertakes the operation of a trade or business and sustains therein a net operating loss of $4,700. In 1961 he sustains a net operating loss of $10,000 in the operation of the business. Under section 172(b)(2), it is determined that the entire amount of each loss, $4,700 and $10,000, is a carryback to 1959. In determining the amount of the carryover of the 1961 loss to 1962, the taxable income for 1959 as computed under this paragraph is $3,870, determined as follows:

Salary	$5,000
Net long-term capital gain	4,000
Total gross income	9,000
Less: Deduction for carryback of 1960 net operating loss	4,700
Adjusted gross income	4,300
Less: Standard deduction	430
Taxable income	3,870

(iii) *Minimum limitation.* The taxable income, as modified under this paragraph, shall in no case be considered less than zero.

(3) *Electing small business corporations.* For special rule applicable to corporations which were electing small business corporations under Subchapter S (section 1361 and following), Chapter 1 of the Code, during one or more of the taxable years described in section 172(b)(1), see paragraph (f) of § 1.172–1.

(4) *Qualified real estate investment trust.* Where a net operating loss is carried over to a qualified taxable year (as defined in § 1.172–10(b)) ending after October 4, 1976, the real estate investment trust taxable income (as defined in section 857(b)(2)) shall be used as the "taxable income" for that taxable year to determine, under section 172(b)(2), the balance of the net operating loss available as a carryover to a subsequent taxable year. The real estate investment trust taxable income, however, is computed by applying the rules applicable to corporations in paragraph (a)(2) of this section. Thus, in computing real estate investment trust taxable income for purposes of section 172(b)(2), the net operating loss deduction for the taxable year shall be computed in accordance with paragraph (a)(2)(i) of this section. The principles of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X, a calendar year taxpayer, is formed on January 1, 1977. X incurs a net operating loss of $100,000 for its taxable year 1977, which under section 172(b)(2), is a carryover to 1978. For 1978 X is a qualified real estate investment trust (as defined in § 1.172–10(b)) and has real estate investment trust taxable income (determined without regard to the deduction for dividends paid or the net operating loss deduction) of $150,000, all of which consists of ordinary income. X pays dividends in 1978 totaling $120,000 that qualify for the deduction for dividends paid under section 857(b)(2)(B). The portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is $70,000 (i.e., the excess of the amount of the net operating loss ($100,000) over the amount of the real estate investment trust taxable income for 1978 ($30,000), determined by taking into account the deduction for dividends paid allowable under section 857(b)(2)(B) and without taking into account the net operating loss of 1977).

Example 2. (i) Assume the same facts as in *Example 1,* except that the $150,000 of real estate investment trust taxable income (determined without the net operating loss deduction or the dividends paid deduction) consists of $80,000 of ordinary income and $70,000 of net capital gain. The amount of capital gain dividends which may be paid for 1978 is limited to $50,000, that is, the amount of the real estate investment trust taxable income for 1978, determined by taking into account the net operating loss deduction for the taxable year, but not the deduction for dividends paid ($150,000 minus $100,000). See § 1.857–6(e)(1)(ii).

(ii) X designated $50,000 of the $120,000 of dividends paid as capital gains dividends (as defined in section 857(b)(3)(C) and § 1.857–6(e)). Thus, $70,000 is an ordinary dividend. Since both ordinary dividends and capital gains dividends are taken into account in computing the deduction for dividends paid under section 857(b)(2)(B), the result will be the same as in *Example 1;* that is, the portion of the 1977 net operating loss available as a carryover to 1979 and subsequent years is $70,000.

(b) [Reserved]

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6862, 30 FR 14428, Nov. 18, 1965; T.D. 6900, 31 FR 14641, Nov. 17, 1966; T.D. 7767, 46 FR 11263, Feb. 6, 1981; T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–6 Illustration of net operating loss carrybacks and carryovers.

The application of § 1.172–4 may be illustrated by the following example:

(a) *Facts.* The books of the taxpayer, whose return is made on the basis of the calendar year, reveal the following facts:

Taxable year	*Taxable income*	*Net operating loss*
1954	$15,000	
1955	30,000	
1956		($75,000)
1957	20,000	
1958		(150,000)
1959	30,000	
1960	35,000	
1961	75,000	
1962	17,000	
1963	53,000	

The taxable income thus shown is computed without any net operating loss deduction. The assumption is also made that none of the other modifications prescribed in § 1.172–5 apply. There are no net operating losses for 1950, 1951, 1952, 1953, 1964, 1965, or 1966.

(b) *Loss sustained in 1956.* The portions of the $75,000 net operating loss for 1956 which shall be used as carrybacks to 1954 and 1955 and as carryovers to 1957, 1958, 1959, 1960, and 1961 are computed as follows:

(1) *Carryback to 1954.* The carryback to this year is $75,000, that is, the amount of the net operating loss.

(2) *Carryback to 1955.* The carryback to this year is $60,000, computed as follows:

Net operating loss	$75,000
Less:	
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	15,000
Carryback	60,000

(3) *Carryover to 1957.* The carryover to this year is $30,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
		45,000
Carryover		30,000

(4) *Carryover to 1958.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
		65,000
Carryover		10,000

(5) *Carryover to 1959.* The carryover to this year is $10,000, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
		65,000
Carryover		10,000

(6) *Carryover to 1960.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	

		95,000
Carryover		0

(7) *Carryover to 1961.* The carryover to this year is $0, computed as follows:

Net operating loss		$75,000
Less:		
Taxable income for 1954 (computed without the deduction of the carryback from 1956)	$15,000	
Taxable income for 1955 (computed without the deduction of the carryback from 1956 or the carryback from 1958)	30,000	
Taxable income for 1957 (computed without the deduction of the carryover from 1956 or the carryback from 1958)	20,000	
Taxable income for 1958 (a year in which a net operating loss was sustained)	0	
Taxable income for 1959 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	30,000	
Taxable income for 1960 (computed without the deduction of the carryover from 1956 or the carryover from 1958)	35,000	
		130,000
Carryover		0

(c) *Loss sustained in 1958.* The portions of the $150,000 net operating loss for 1958 which shall be used as carrybacks to 1955, 1956, and 1957 and as carryovers to 1959, 1960, 1961, 1962, and 1963 are computed as follows:

(1) *Carryback to 1955.* The carryback to this year is $150,000, that is, the amount of the net operating loss.

(2) *Carryback to 1956.* The carryback to this year is $150,000, computed as follows:

Net operating loss	$150,000
Less:	
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0
Carryback	150,000

(3) *Carryback to 1957.* The carryback to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
		0
Carryback		150,000

(4) *Carryover to 1959.* The carryover to this year is $150,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
		0
Carryover		150,000

(5) *Carryover to 1960.* The carryover to this year is $130,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
		20,000
Carryover		130,000

(6) *Carryover to 1961.* The carryover to this year is $95,000, computed as follows:

Net operating loss		$150,000

Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
		55,000
Carryover		95,000

(7) *Carryover to 1962.* The carryover to this year is $20,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
		130,000
Carryover		20,000

(8) *Carryover to 1963.* The carryover to this year is $3,000, computed as follows:

Net operating loss		$150,000
Less:		
Taxable income for 1955 (the $30,000 taxable income for such year reduced by the carryback to such year of $60,000 from 1956, the carryback from 1958 to 1955 not being taken into account)	0	
Taxable income for 1956 (a year in which a net operating loss was sustained)	0	
Taxable income for 1957 (the $20,000 taxable income for such year reduced by the carryover to such year of $30,000 from 1956, the carryback from 1958 to 1957 not being taken into account)	0	
Taxable income for 1959 (the $30,000 taxable income for such year reduced by the carryover to such year of $10,000 from 1956, the carryover from 1958 to 1959 not being taken into account)	$20,000	
Taxable income for 1960 (the $35,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1960 not being taken into account)	35,000	
Taxable income for 1961 (the $75,000 taxable income for such year reduced by the carryover to such year of $0 from 1956, the carryover from 1958 to 1961 not being taken into account)	75,000	
Taxable income for 1962 (computed without the deduction of the carryover from 1958)	17,000	
		147,000
Carryover		3,000

(d) *Determination of net operating loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the net operating loss deduction in the following manner:

Taxable year	Carryover		Carryback		Net operating loss deduction
	From 1956	From 1958	From 1956	From 1958	
1954	$0	$0	$75,000	$0	$75,000
1955	0	0	60,000	150,000	210,000
1957	30,000	0	0	150,000	180,000
1959	10,000	150,000	0	0	160,000
1960	0	130,000	0	0	130,000
1961	0	95,000	0	0	95,000
1962	0	20,000	0	0	20,000
1963	0	3,000	0	0	3,000

§ 1.172–7 Joint return by husband and wife.

(a) *In general.* This section prescribes additional rules for computing the net operating loss carrybacks and carryovers of a husband and wife making a joint return for one or more of the taxable years involved in the computation of the net operating loss deduction.

(b) *From separate to joint return.* If a husband and wife, making a joint return for any taxable year, did not make a joint return for any of the taxable years involved in the computation of a net operating loss carryover or a net operating loss carryback to the taxable year for which the joint return is made, such separate net operating loss carryover or separate net operating loss carryback is a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(c) *Continuous use of joint return.* If a husband and wife making a joint return for a taxable year made a joint return for each of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the joint net operating loss carryover or joint net operating loss carryback to such taxable year is computed in the same manner as the net operating loss carryover or net operating loss carryback of an individual under §1.172–4 but upon the basis of the joint net operating losses and the combined taxable income of both spouses.

(d) *From joint to separate return.* If a husband and wife making separate returns for a taxable year made a joint return for any, or all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, the separate net operating loss carryover or separate net operating loss carryback of each spouse to the taxable year is computed in the manner set forth in §1.172–4 but with the following modifications:

(1) *Net operating loss.* The net operating loss of each spouse for a taxable year for which a joint return was made shall be deemed to be that portion of the joint net operating loss (computed in accordance with paragraph (d) of §1.172–3) which is attributable to the gross income and deductions of such spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing the joint net operating loss.

(2) *Taxable income to be subtracted*—(i) *Net operating loss of other spouse.* The taxable income of a particular spouse for any taxable year which is subtracted from the net operating loss of such spouse for another taxable year in order to determine the amount of such loss which may be carried back or carried over to still another taxable year is deemed to be, in a case in which such taxable income was reported in a joint return, the sum of the following:

(*a*) That portion of the combined taxable income of both spouses for such year for which the joint return was made which is attributable to the gross income and deductions of the particular spouse, gross income and deductions being taken into account to the same extent that they are taken into account in computing such combined taxable income, and

(*b*) That portion of such combined taxable income which is attributable to the other spouse; but, if such other spouse sustained a net operating loss in a taxable year beginning on the same date as the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted, then such portion shall first be reduced by such net operating loss of such other spouse.

(ii) *Modifications.* For purposes of this subparagraph, the combined taxable income shall be computed as though the combined income and deductions of both spouses were those of one individual. The provisions of § 1.172–5 shall apply in computing the combined taxable income for such purposes except that the net operating loss deduction shall be determined without taking into account any separate net operating loss of either spouse, or any joint net operating loss of both spouses, which was sustained in a taxable year beginning on or after the date of the beginning of the taxable year in which the particular spouse sustained the net operating loss from which the taxable income is subtracted.

(e) *Recurrent use of joint return.* If a husband and wife making a joint return for any taxable year made a joint return for one or more, but not all, of the taxable years involved in the computation of a net operating loss carryover or net operating loss carryback to such taxable year, such net operating loss carryover or net operating loss carryback to the taxable year is computed in the manner set forth in paragraph (d) of this section. Such net operating loss carryover or net operating loss carryback is considered a joint net operating loss carryover or joint net operating loss carryback to such taxable year.

(f) *Joint carryovers and carrybacks.* The joint net operating loss carryovers and the joint net operating loss carrybacks to any taxable year for which a joint return is made are all the net operating loss carryovers and net operating loss carrybacks of both spouses to such taxable year. For example, a husband and wife file a joint return for the calendar year 1956, having a joint taxable income for such year. The wife filed a separate return for the calendar years 1954 and 1955, in which years she sustained net operating losses. The husband filed separate returns for his fiscal year ending June 30, 1955, and, having received permission to change his accounting period to a calendar year basis, for the 6-month period ending December 31, 1955. The husband sustained net operating losses in both such taxable years. Since the husband and wife did not file a joint return for any taxable year involved in the computation of the net operating loss carryovers to 1956 from 1954 and 1955, the joint net operating loss carryovers to 1956 are the separate net operating loss carryovers of the wife from the calendar years 1954 and 1955 and the separate net operating loss carryovers of the husband from the fiscal year ending June 30, 1955, and from the short taxable year ending December 31, 1955. If the husband and wife also file joint returns for the calendar years 1957, 1958, and 1959, having joint taxable income in 1957 and 1958 and a joint net operating loss in 1959, the joint net operating loss carrybacks to 1956, 1957, and 1958 from 1959 are computed on the basis of the joint net operating loss for 1959, since separate returns were not made for any taxable year involved in the computation of such carrybacks.

(g) *Illustration of principles.* In the following examples, which illustrate the application of this section, it is assumed that there are no items of adjustment under section 172(b)(2)(A) and that the taxable income or loss in each case is the taxable income or loss determined without any net operating loss deduction. The taxpayers in each example, H, a husband, and W, his wife, report their income on the calendar-year basis.

Example 1. H and W filed joint returns for 1954 and 1955. They sustained a joint net operating loss of $1,000 for 1954 and a joint net operating loss of $2,000 for 1955. For 1954 the deductions of H exceeded his gross income by $700, and the deductions of W exceeded her gross income by $300, the total of such amounts being $1,000. Therefore, $700 of the $1,000 joint net operating loss for 1954 is considered the net operating loss of H for 1954, and $300 of such joint net operating loss is considered the net operating loss of W for 1954. For 1955 the gross income of H exceeded his deductions, so that his separate taxable income would be $1,500, and the deductions of W exceeded her gross income by $3,500. Therefore, all of the $2,000 joint net operating loss for 1955 is considered the separate net operating loss of W for 1955.

Example 2. (i) H and W filed joint returns for 1954 and 1956, and separate returns for 1955 and 1957. For the years 1954, 1955, 1956, and 1957 they had taxable incomes and net operating losses as follows, losses being indicated in parentheses:

	1954	1955	1956	1957
H	($5,000)	($2,500)	$6,500	($4,000)
W	(3,000)	2,000	3,000	(1,500)
Total	(8,000)	....	9,500	....

(ii) The net operating loss carryover of H from 1957 to 1958 is $4,000, that is, his $4,000 net operating loss for 1957 which is not reduced by any part of the taxable income for 1956, since none of such taxable income is attributable to H and the portion attributable to W is entirely offset by her separate net operating loss for her taxable year 1957, which taxable year begins on the same date as H's taxable year 1957. H's $4,000 net operating loss for 1957 likewise is not reduced by reference to 1955 since H sustained a loss in 1955. The $0 taxable income for 1956 which reduces H's net operating loss for 1957 is computed as follows:

(iii) The combined taxable income of $9,500 for 1956 is reduced to $1,000 by the net operating loss deduction for such year of $8,500. This net operating loss deduction is computed without taking into account any net operating loss of either H or W sustained in a taxable year beginning on or after January 1, 1957, the date of the beginning of the taxable year in which H sustained the net operating loss from which the taxable income is subtracted. This $8,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955, and of W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). None of the $1,000 combined taxable income for 1956 (computed with the net operating loss deduction described above) is attributable to H since it is caused by W's income (computed after deducting her separate carryover) offsetting H's loss (computed by deducting from his income his separate carryovers). No part of the $1,000 combined taxable income for 1956 which is attributable to W is used to reduce H's net operating loss for 1957 since such taxable income attributable to W must first be reduced by W's $1,500 net operating loss for 1957, her taxable year beginning on the same date as the taxable year of H in which he sustained the net operating loss from which the taxable income is subtracted.

(iv) The net operating loss carryover of W from 1957 to 1958 is $500, her $1,500 loss reduced by the sum of her $0 taxable income for 1955 (computed by taking into account her $3,000 carryover from 1954) and her $1,000 taxable income for 1956, that is, the portion of the combined taxable income for 1956 which is attributable to her.

Example 3. (i) Assume the same facts as in *Example 2* except that for 1957 the net operating loss of W is $200 instead of $1,500.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,200, that is, his $4,000 net operating loss for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $800 taxable income for 1956. Such $800 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in *Example 2,* remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added $800, the excess of the $1,000 taxable income for such year attributable to W over her $200 net operating loss sustained in 1957, a taxable year beginning on the same date as the taxable year of H in which he sustained the $4,000 net operating loss from which the taxable income is subtracted.

(iv) W has no net operating loss carryover from 1957 to 1958 since her net operating loss of $200 for 1957 does not exceed the $1,000 taxable income for 1956 attributable to her.

Example 4. (i) Assume the same facts as in *Example 2,* except that W changes her accounting period in 1957 to a fiscal year ending on January 31, and has neither income nor losses for the taxable year January 1, 1957, to January 31, 1957, or for the fiscal year February 1, 1957, to January 31, 1958, but has a net operating loss of $200 for the fiscal year February 1, 1958, to January 31, 1959.

(ii) The net operating loss carryover of H from 1957 to 1958 is $3,000, that is, his net operating loss of $4,000 for 1957 reduced by the sum of his $0 taxable income for 1955 (a year in which he sustained a loss) and his $1,000 taxable income for 1956. Such $1,000 is computed as follows:

(iii) The combined taxable income for 1956, computed with the net operating loss deduction in the manner described in *Example 2,* remains $1,000, no part of which is attributable to H. To the $0 taxable income attributable to H for 1956 there is added the $1,000 taxable income attributable to W for such year. The taxable income attributable to W is not reduced by any amount since she does not have a net operating loss for her taxable year beginning on January 1, 1957, the date of the beginning of the taxable year of H in which he sustained the $4,000 net operating loss from which his taxable income is subtracted.

(iv) The net operating loss carryover of W from the fiscal year beginning February 1, 1958, to her next fiscal year is $200, that is, her net operating loss of $200 for the fiscal year beginning February 1, 1958, reduced by the sum of her $0 taxable income for 1956, her $0 taxable income for the taxable year January 1, 1957, to January 31, 1957 (a year in which she had neither income nor loss), and her $0 taxable income for the fiscal year February 1, 1957, to January 31, 1958 (also a year in which she had neither income nor loss). The $0 taxable income for 1956 is computed as follows:

(v) The combined taxable income of $9,500 for 1956 is reduced to $0 amount by the net operating loss deduction for such year of $12,500. This net operating loss deduction is computed by taking into account the net operating loss of H for 1957 since it was sustained in a taxable year beginning before February 1, 1958, the date of the beginning of the taxable year of W in which she sustained the $200 net operating loss from which her taxable income is subtracted. This $12,500 is composed of H's carryovers of $5,000 from 1954 and $2,500 from 1955 and of his carryback of $4,000 from 1957, plus W's carryover of $1,000 from 1954 (the excess of W's $3,000 loss for 1954 over her $2,000 income for 1955). Since there is no combined taxable income for 1956, there is no taxable income attributable to W for such year.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–8 Net operating loss carryovers for regulated transportation corporations.

(a) *In general.* A net operating loss sustained in a taxable year ending before January 1, 1976, shall be a carryover to the 7 succeeding taxable years if the taxpayer is a regulated transportation corporation (as defined in paragraph (b) of this section) for the loss year and for the 6th and 7th succeeding taxable years. If, however, the taxpayer is a regulated transportation corporation for the loss year and for the 6th succeeding taxable year, but not for the 7th succeeding taxable year, then the loss shall be a carryover to the 6 succeeding taxable years. If the taxpayer is not a regulated transportation corporation for the 6th succeeding taxable year then this section shall not apply. A net operating loss sustained in a taxable year ending after December 31, 1975, shall be a carryover to the 15 succeeding taxable years.

(b) *Regulated transportation corporations.* A corporation is a *regulated transportation corporation* for a taxable year if it is included within one or more of the following categories:

(1) Eighty percent or more of the corporation's gross income (computed without regard to dividends and capital gains and losses) for such taxable year is income from transportation sources described in paragraph (c) of this section.

(2) The corporation is a railroad corporation, subject to Part I of the Interstate Commerce Act, which is either a lessor railroad corporation described in section 7701(a)(33)(G) or a common parent railroad corporation described in section 7701(a)(33)(H).

(3) The corporation is a member of a regulated transportation system for the taxable year. For purposes of this section, a member of a regulated transportation system for a taxable year means a member of an affiliated group of corporations making a consolidated return for such year, if 80 percent or more of the sum of the gross incomes of the members of the affiliated group for such year (computed without regard to dividends, capital gains and losses, or eliminations for intercompany transactions) is derived from transportation sources described in paragraph (c) of this section. For purposes of this subparagraph, income derived by a corporation described in subparagraph (2) of this paragraph from leases described in section 7701(a)(33)(G) shall be considered as income from transportation sources described in paragraph (c) of this section.

(c) *Transportation sources.* For purposes of this section, income from ''transportation sources'' means income received directly in consideration for transportation services, and income from the furnishing or sale of essential facilities, products, and other services which are directly necessary and incidental to the furnishing of transportation services. For purposes of the preceding sentence, the term *transportation services* means:

(1) Transportation by railroad as a common carrier subject to the jurisdiction of the Interstate Commerce Commission;

(2)(i) Transportation, which is not included in subparagraph (1) of this paragraph:

(*a*) On an intrastate, suburban, municipal, or interurban electric railroad,

(*b*) On an intrastate, municipal, or suburban trackless trolley system,

(*c*) On a municipal or suburban bus system, or (*d*) By motor vehicle not otherwise included in this subparagraph, if the rates for the furnishing or sale of such transportation are established or approved by a regulatory body described in section 7701(a)(33)(A);

(ii) In the case of a corporation which establishes to the satisfaction of the district director that:

(*a*) Its revenue from regulated rates from transportation services described in subdivision (i) of this subparagraph and its revenue derived from unregulated rates are derived from its operation of a single interconnected and coordinated system or from the operation of more than one such system, and

(*b*) The unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, transportation, which is not included in subparagraph (1) of this paragraph, from which such revenue from unregulated rates is derived.

(3) Transportation by air as a common carrier subject to the jurisdiction of the Civil Aeronautics Board; and

(4) Transportation by water by common carrier subject to the jurisdiction of either the Interstate Commerce Commission under Part III of the Interstate Commerce Act (54 Stat. 929), or the Federal Maritime Board under the Intercoastal Shipping Act, 1933 (52 Stat. 965).

(d) *Corporate acquisitions.* This section shall apply to a carryover of a net operating loss sustained by a regulated transportation corporation (as defined in paragraph (b) of this section) to which an acquiring corporation succeeds under section 381(a) only if the acquiring corporation is a regulated transportation corporation (as defined in paragraph (b) of this section):

(1) For the sixth succeeding taxable year in the case of a carryover to the sixth succeeding taxable year, and

(2) For the sixth and seventh succeeding taxable years in the case of a carryover to the seventh succeeding taxable year.

[T.D. 6862, 30 FR 14430, Nov. 18, 1965, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–9 Election with respect to portion of net operating loss attributable to foreign expropriation loss.

(a) *In general.* If a taxpayer has a net operating loss for a taxable year ending after December 31, 1958, and if the foreign expropriation loss for such year (as defined in paragraph (b)(1) of this section) equals or exceeds 50 percent of the net operating loss for such year, then the taxpayer may elect (at the time and in the manner provided in paragraph (c) (1) or (2) of this section, whichever is applicable) to have the provisions of this section apply. If the taxpayer so elects, the portion of the net operating loss for such taxable year attributable (under paragraph (b)(2) of this section) to such foreign expropriation loss shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss and shall be a net operating loss carryover to each of the ten taxable years following the taxable year of such loss. In such case, the portion, if any, of the net operating loss not attributable to a foreign expropriation loss shall be carried back or carried over as provided in paragraph (a)(1)(ii) of § 1.172–4.

(b) *Determination of ''foreign expropriation loss''*—(1) *Definition of ''foreign expropriation loss''.* The term *foreign expropriation loss* means, for any taxable year, the sum of the losses allowable as deductions under section 165 (other than losses from, or which under section 165(g) or 1231(a) are treated or considered as losses from, sales or exchanges of capital assets and other than losses described in section 165(i)(1)) sustained by reason of the expropriation, intervention, seizure, or similar taking of property by the government or any foreign country, any political subdivision thereof, or any agency or instrumentality of the foregoing. For purposes of the preceding sentence, a debt which becomes worthless in whole or in part, shall, to the extent of any deduction allowed under section 166(a), be treated as a loss allowable as a deduction under section 165.

(2) *Portion of the net operating loss attributable to a foreign expropriation loss.* (i) Except as provided in subdivision (ii) of this subparagraph, the portion of the net operating loss for any taxable

year attributable to a foreign expropriation loss is the amount of the foreign expropriation loss for such taxable year (determined under subparagraph (1) of this paragraph).

(ii) The portion of the net operating loss for a taxable year attributable to a foreign expropriation loss shall not exceed the amount of the net operating loss, computed under section 172(c), for such year.

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

Example 1. M Corporation, a domestic calendar year corporation manufacturing cigars in the United States, owns, in country X, a tobacco plantation having an adjusted basis of $400,000 and farm equipment having an adjusted basis of $300,000. On January 15, 1961, country X expropriates the plantation and equipment without any allowance for compensation. For the taxable year 1961, M Corporation sustains a loss from the operation of its business (not including losses from the seizure of its plantation and equipment in country X) of $200,000, which loss would not have been sustained in the absence of the seizure. Accordingly, M has a net operating loss of $900,000 (the sum of $400,000, $300,000, and $200,000). For purposes of section 172(k)(1), M Corporation has a foreign expropriation loss for 1961 of $700,000 (the sum of $400,000 and $300,000, the losses directly sustained by reason of the seizure of its property by country X). Since the foreign expropriation loss for 1961, $700,000, equals or exceeds 50 percent of the net operating loss for such year, or $450,000 (i.e., 50 percent of $900,000), M Corporation may make the election under paragraph (c)(2) of this section with respect to $700,000, the portion of the net operating loss attributable to the foreign expropriation loss.

Example 2. Assume the same facts as in *Example 1* except that for 1961, M Corporation has operating profits of $300,000 (not including losses from the seizure of its plantation and equipment in country X) so that its net operating loss (as defined in section 172(c)) is only $400,000. Under the provisions of section 172(k)(2) and paragraph (b)(2) of this section, the portion of the net operating loss for 1961 attributable to a foreign expropriation loss is limited to $400,000, the amount of the net operating loss.

(c) *Time and manner of making election*—(1) *Taxable years ending after December 31, 1963*. In the case of a taxpayer who has a foreign expropriation loss for a taxable year ending after December 31, 1963, the election referred to in paragraph (a) of this section shall be made by attaching to the taxpayer's income tax return (filed within the time prescribed by law, including extensions of time) for the taxable year of such foreign expropriation loss a statement containing the information required by subparagraph (3) of this paragraph. Such election shall be irrevocable after the due date (including extensions of time) of such return.

(2) *Information required*. The statement referred to in subparagraph (1) of this paragraph shall contain the following information:

(i) The name, address, and taxpayer account number of the taxpayer;

(ii) A statement that the taxpayer elects under section 172(b)(3)(A)(ii) or (iii), whichever is applicable, to have section 172(b)(1)(D) of the Code apply;

(iii) The amount of the net operating loss for the taxable year; and

(iv) The amount of the foreign expropriation loss for the taxable year, including a schedule showing the computation of such foreign expropriation loss.

(d) *Amount of foreign expropriation loss which is a carryover to the taxable year in issue*—(1) *General*. If a portion of a net operating loss for the taxable year is attributable to a foreign expropriation loss and if an election under paragraph (a) of this section has been made with respect to such portion of the net operating loss, then such portion shall be considered to be a separate net operating loss for such year, and, for the purpose of determining the amount of such separate loss which may be carried over to other taxable years, such portion shall be applied after the other portion (if any) of such net operating loss. Such separate loss shall be carried to the earliest of the several taxable years to which such separate loss is allowable as a carryover under the provisions of paragraph (a)(1)(iv) of § 1.172–4, and the amount of such separate loss which shall be carried over to any taxable year subsequent to such earliest year is an amount (not exceeding such separate loss) equal to the excess of:

(i) The sum of (*a*) such separate loss and (*b*) the other portion (if any) of the net operating loss (i.e., that portion not attributable to a foreign expropriation loss) to the extent such other portion is a carryover to such earliest taxable year, over

(ii) The sum of the aggregate of the taxable incomes (computed as provided in §1.172–5) for all of such several taxable years preceding such subsequent taxable year.

(2) *Cross reference.* The portion of a net operating loss which is not attributable to a foreign expropriation loss shall be carried back or carried over, in accordance with the rules provided in paragraph (b)(1) of §1.172–4, as if such portion were the only net operating loss for such year.

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

Example 1. Corporation A, organized in 1960 and whose return is made on the basis of the calendar year, incurs for 1960 a net operating loss of $10,000, of which $7,500 is attributable to a foreign expropriation loss. With respect to such $7,500, A makes the election described in paragraph (a) of this section. In each of the years 1961, 1962, 1963, 1964, and 1965, A has taxable income in the amount of $600 (computed without any net operating loss deduction). The assumption is made that none of the other modifications prescribed in §1.172–5 apply. The portion of the net operating loss attributable to the foreign expropriation loss which is a carryover to the year 1966 is $7,000, which is the sum of $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss) and $2,500 (the other portion of the net operating loss available as a carryover to 1961), minus $3,000 (the aggregate of the taxable incomes for taxable years 1961 through 1965).

Example 2. Assume the same facts as in *Example 1* except that taxable income for each of the years 1961 through 1965 is $400 (computed without any net operating loss deduction). The carryover to the year 1966 is $7,500, that is, the sum of $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss) and $2,500 (the other portion of the net operating loss available as a carryover to 1961), minus $2,000 (the aggregate of the taxable incomes for taxable years 1961 through 1965), but limited to $7,500 (the portion of the net operating loss attributable to the foreign expropriation loss).

(e) *Taxable income which is subtracted from net operating loss to determine carryback or carryover.* In computing taxable income for a taxable year (hereinafter called a ''prior taxable year'') for the purpose of determining the portion of a net operating loss for another taxable year which shall be carried to each of the several taxable years subsequent to the earliest taxable year to which such loss may be carried, the net operating loss deduction for any such prior taxable year shall be determined without regard to that portion, if any, of a net operating loss for a taxable year attributable to a foreign expropriation loss, if such portion may not, under the provisions of section 172(b)(1)(D) and paragraph (a)(1)(iv) of §1.172–4, be carried back to such prior taxable year. Thus, if the taxpayer has a foreign expropriation loss for 1962 and elects the 10-year carryover with respect to the portion of his net operating loss for 1962 attributable to the foreign expropriation loss, then in computing taxable income for the year 1960 for the purpose of determining the portion of a net operating loss for 1963 which is carried to years subsequent to 1960, the net operating loss deduction for 1960 is determined without regard to the portion of the net operating loss for 1962 attributable to the foreign expropriation loss, since under the provisions of section 172(b)(1)(D) and paragraph (a)(1)(iv) of §1.172–4 such portion of the net operating loss for 1962 may not be carried back to 1960.

[T.D. 6862, 30 FR 14431, Nov. 18, 1965, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§1.172–10 Net operating losses of real estate investment trusts.

(a) *Taxable years to which a loss may be carried.* (1) A net operating loss sustained by a qualified real estate investment trust (as defined in paragraph (b)(1) of this section) in a qualified taxable year (as defined in paragraph (b)(2) of this section) ending after October 4, 1976, shall not be carried back to a preceding taxable year.

(2) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending before October 5, 1976, shall be carried back to the 3 preceding taxable years. However, see §1.857–2(a)(5), which does not allow the net operating loss deduction in computing real estate investment trust taxable income for taxable years ending before October 5, 1976.

(3) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending after December 31, 1972, shall be carried over to the 15 succeeding taxable years. However, see § 1.857–2(a)(5).

(4) A net operating loss sustained by a qualified real estate investment trust in a qualified taxable year ending before January 1, 1973, shall be carried over to 8 succeeding taxable years. However, see § 1.857–2(a)(5).

(5) A net operating loss sustained in a taxable year for which the taxpayer is not a qualified real estate investment trust generally may be carried back to the 3 preceding taxable years; however, a net operating loss sustained in a taxable year ending after December 31, 1975, shall not be carried back to any qualified taxable year. However, see § 1.857–2(a)(5), with respect to a net operating loss sustained in a taxable year ending before January 1, 1976.

(6) A net operating loss sustained in a taxable year ending after December 31, 1975, for which the taxpayer is not a qualified real estate investment trust generally may be carried over to the 15 succeeding taxable years.

(7)(i) A net operating loss sustained in a taxable year ending before January 1, 1986, for which the taxpayer is not a qualified real estate investment trust generally may be a net operating loss carryover to each of the 5 succeeding taxable years. However, where the loss was a net operating loss carryback to one or more qualified taxable years, the net operating loss, in accordance with paragraph (a)(7)(ii) of this section shall be—

(A) Carried over to the 15 succeeding taxable years if the loss could be a net operating loss carryover to a taxable year ending in 1981, or

(B) Carried over to the 5, 6, 7, or 8 succeeding taxable years if paragraph (a)(7)(i)(A) of this section does not apply.

(ii) For purposes of determining whether a net operating loss could be a carryover to a taxable year ending in 1981 under paragraph (a)(7)(i)(A) of this section or, where paragraph (a)(7)(i)(A) of this section does not apply, to determine the actual carryover period under paragraph (a)(7)(i)(B) of this section, the net operating loss shall have a carryover period of 5 years, and such period shall be increased (to a number not greater than 8) by the number of qualified taxable years to which such loss was a net operating loss carryback; however, where the taxpayer acted so as to cause itself to cease to be a qualified real estate investment trust and the principal purpose for such action was to secure the benefit of the allowance of a net operating loss carryover under section 172(b)(1)(B), the net operating loss carryover period shall be limited to 5 years. However, see § 1.857–2(a)(5).

(8) A qualified taxable year is a taxable year preceding or following the taxable year of the net operating loss, for purposes of section 172(b)(1), even though the loss may not be carried to, or allowed as a deduction in, such qualified taxable year. Thus, a qualified taxable year ending before October 5, 1976 (for which no net operating loss deduction is allowable) is nevertheless a preceding or following taxable year for purposes of section 172(b)(1). Moreover, a qualified taxable year ending after October 4, 1976 (to which a net operating loss cannot be carried back because of section 172(b)(1)(E)) is nevertheless a preceding taxable year for purposes of section 172(b)(1). For purposes of determining, under section 172(b)(2), the balance of the loss available as a carryback or carryover to other taxable years, however, the net operating loss is not reduced on account of such qualified taxable year being a preceding or following taxable year.

(b) *Definitions.* For purposes of this section and §§ 1.172–2 and 1.172–5:

(1) The term *qualified real estate investment trust* means, with respect to any taxable year, a real estate investment trust within the meaning of part II of subchapter M which is taxable for such year under that part as a real estate investment trust, and

(2) The term *qualified taxable year* means a taxable year for which the taxpayer is a qualified real estate investment trust.

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

Example 1. (i) *Facts.* X was a qualified real estate investment trust for the taxable years ending on December 31, 1972, and December 31, 1973. X was not a qualified real estate investment trust for the taxable years ending on December 31, 1971, and December 31, 1974. X sustained a net operating loss for the taxable year ending on December 31, 1974.

(ii) *Applicable carryback and carryover periods.* The net operating loss must be carried back to the 3 preceding taxable years. Under §1.857–2 (a)(5) the net operating loss deduction shall not be allowed in computing real estate investment trust taxable income for the years ending December 31, 1972, and December 31, 1973. Where a net operating loss is sustained in a taxable year ending before January 1, 1976, for which the taxpayer is not a qualified real estate investment trust and the loss is a net operating loss carryback to one or more qualified taxable years, the carryover period is determined under §1.172–10 (a)(7); the carryover period is determined by first applying the rule provided in paragraph (a)(7)(ii) of this section to obtain the carryover period for purposes of determining whether the net operating loss could have been a net operating loss carryover to a taxable year ending in 1981. Under these facts, paragraph (a)(7)(ii) of this section provides for a 7-year carryover period (5 years increased by the 2 qualified taxable years to which the loss was a net operating loss carryback); therefore, since the carryover period provided for by paragraph (a)(7)(ii) of this section would allow the net operating loss to be a net operating loss carryover to a taxable year ending in 1981, under paragraph (a)(7)(ii)(A) of this section the applicable carryover period is 15 years (provided that X did not act so as to cause itself to cease to qualify as a real estate investment trust for the principal purpose of securing the benefit of a net operating loss carryover under section 172 (b)(1)(B)).

Example 2. (i) *Facts.* The facts are the same as in *example* (1) except that the taxable year ending December 31, 1973, was not a qualified taxable year for X.

(ii) *Applicable carryback and carryover periods.* The net operating loss must be carried back to the 3 preceding taxable years. Section 1.857–2 (a)(5) provides that the net operating loss deduction shall not be allowed in computing real estate investment trust taxable income for the year ending December 31, 1972. Under these facts the carryover period is determined under §1.172–10 (a)(7). Paragraph (a)(7)(ii) of this section provides for a 6 year carryover period (5 years increased by the 1 qualified taxable year to which the loss was a net operating loss carryback); therefore, since a 6 year carryover period would not allow the net operating loss to be a net operating loss carryover to a taxable year ending in 1981, paragraph (a)(7)(i)(A) of this section does not apply. Where the rule stated in paragraph (a)(7)(i)(A) of this section does not apply, paragraph (a)(7)(i)(B) of this section provides that the applicable carryover period is the carryover period determined under paragraph (a)(7)(ii) of this section, which, in this case, is 6 years (provided that the principal purpose for X acting so as to cause itself to cease to qualify as a real estate investment trust was not to secure the benefit of the allowance of a net operating loss carryover under section 172 (b)(1)(B)).

(d) *Cross references.* See §§1.172–2(c) and 1.172–5(a)(5) for the computation of the net operating loss of a qualified real estate investment trust for a taxable year ending after October 4, 1976, and the amount of a net operating loss which is absorbed when carried over to a qualified taxable year ending after October 4, 1976. See §1.857–2(a)(5), which provides that for a taxable year ending before October 5, 1976, the net operating loss deduction is not allowed in computing the real estate investment trust taxable income of a qualified real estate investment trust.

[T.D. 7767, 46 FR 11263, Feb. 6, 1981, as amended by T.D. 8107, 51 FR 43346, Dec. 2, 1986]

§ 1.172–13 Product liability losses.

(a) *Entitlement to 10-year carryback*—(1) *In general.* Unless an election is made pursuant to paragraph (c) of this section, in the case of a taxpayer which has a product liability loss (as defined in section 172(j) and paragraph (b)(1) of this section) for a taxable year beginning after September 30, 1979 (hereinafter ''loss year''), the product liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the loss year.

(2) *Years to which loss may be carried.* A product liability loss shall first be carried to the earliest of the taxable years to which such loss is allowable as a carryback and shall then be carried to the next earliest of such taxable years, etc.

(3) *Example.* The application of this paragraph may be illustrated as follows:

Example. Taxpayer A incurs a net operating loss for taxable year 1980 of $80,000, of which $60,000 is a product liability loss. A's taxable income for each of the 10 years immediately preceding taxable year 1980 was $5,000. The product liability loss of $60,000 is first carried back to the 10th through the 4th preceding taxable years ($5,000 per year), thus offsetting $35,000 of the loss. The remaining $25,000 of product liability loss is added to the remaining portion of the total net operating loss for taxable year 1980 which was not a product liability loss ($20,000), and the total is then carried back to the 3rd through 1st years preceding taxable year 1980, which offsets $15,000 of this loss. The remaining loss ($30,000) is carried forward pursuant to section 172(b)(1) and the regulations thereunder without regard to whether all or any portion thereof originated as a product liability loss.

(b) *Definitions*—(1) *Product liability loss*. The term *product liability loss* means, for any taxable year, the lesser of—

(i) The net operating loss for the current taxable year (not including the portion of such net operating loss attributable to foreign expropriation losses, as defined in § 1.172–11), or

(ii) The total of the amounts allowable as deductions under sections 162 and 165 directly attributable to—

(A) Product liability (as defined in paragraph (b)(2) of this section), and

(B) Expenses (including settlement payments) incurred in connection with the investigation or settlement of or opposition to claims against the taxpayer on account of alleged product liability.

Indirect corporate expense, or overhead, is not to be allocated to product liability claims so as to become a product liability loss.

(2) *Product liability*. (i) The term *product liability* means the liability of a taxpayer for damages resulting from physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer. The preceding sentence applies only to the extent that the injury, harm, or damage occurs after the taxpayer has completed or terminated operations with respect to the product, including, but not limited to the manufacture, installation, delivery, or testing of the product, and has relinquished possession of such product.

(ii) The term *product liability* does not include liabilities arising under warranty theories relating to repair or replacement of the property that are essentially contract liabilities. For example, the costs incurred by a taxpayer in repairing or replacing defective products under the terms of a warranty, express or implied, are not product liability losses. On the other hand, the taxpayer's liability for damage done to other property or for harm done to persons that is attributable to a defective product may be product liability losses regardless of whether the claim sounds in tort or contract. Further, liability incurred as a result of services performed by a taxpayer is not product liability. For purposes of the preceding sentence, where both a product and services are integral parts of a transaction, product liability does not arise until all operations with respect to the product are completed and the taxpayer has relinquished possession of it. On the other hand, any liability that arises after completion of the initial delivery, installation, servicing, testing, etc., is considered ''product liability'' even if such liability arises during the subsequent servicing of the product pursuant to a service agreement or otherwise.

(iii) Liability for injury, harm, or damage due to a defective product as described in this subparagraph shall be ''product liability'' notwithstanding that the liability is not considered product liability under the law of the State in which such liability arose.

(iv) Amounts paid for insurance against product liability risks are not paid on account of product liability.

(v) Notwithstanding subparagraph (iv), an amount is paid on account of product liability (even if such amount is paid to an insurance company) if the amount satisifies the provisions of paragraph (b)(2) (i) through (iii) of this section and the amount—

(A) Is paid on account of specific claims against the taxpayer (or on account of expenses incurred in connection with the investigation or settlement of or opposition to such claims), subsequent to the events giving rise to the claims and pursuant to a contract entered into before those events,

(B) Is not refundable, and

(C) Is not applicable to other claims, other expenses or to subsequent coverage.

(3) *Examples*. Paragraph (b)(2) of this section is illustrated by the following examples:

Example 1. X, a manufacturer of heating equipment, sells a boiler to A, a homeowner.

Subsequent to the sale and installation of the boiler, the boiler explodes due to a defect causing physical injury to A. A sues X for damages for the injuries sustained in the explosion and is awarded $250,000, which X pays. The payment was made on account of product liability.

Example 2. Assume the same facts as in *Example 1* and that A also sues under the contract with X to recover for the cost of the boiler and recovers $1,000, the boiler's replacement cost. The $1,000 payment is not a payment on account of product liability. Similarly, if X agrees to repair the destroyed boiler, any amount expended by X for such repair is not payment made on account of product liability.

Example 3. Y, a professional medical association, is sued by B, a patient, in an action based on the malpractice of one of its doctors. B recovers $25,000. Because the suit was based on the services of B, the payment is not made on account of product liability.

Example 4. R, a retailer of communications equipment, sells a telecommunication device to C. R also contracts with C to service the equipment for 3 years. While R is installing the equipment, the unit catches on fire due to faulty wiring within the unit and destroys C's office. Because R had not relinquished possession of this equipment when the fire started, any amount paid to C by R for the damage to C's property on account of the defective product is not payment on account of product liability.

Example 5. Assume the same facts as in *Example 4* except that the fire and resulting property damages occurred after R had installed the equipment and relinquished possession of it. Any amount paid for the property damages sustained on account of the defective product is payment on account of product liability.

Example 6. Assume the same facts as in *Example 4* except that the equipment catches on fire during the subsequent servicing of the unit. Because C is in possession of the unit during the servicing, any amount paid for the property damage sustained on account of the defective product would be payment on account of product liability.

Example 7. X, a manufacturer of computers, sells a computer to A. X also has its employees periodically service the computer for A from time to time after it is placed in service. After the initial delivery, installation, servicing, and testing of the computer is completed, the computer catches on fire while X's employee is servicing the equipment. This fire causes property damage to A's office and physical injury to A. Any amount paid for the property or physical damage sustained on account of the defective product is payment on account of product liability.

(c) *Election*—(1) *In general.* The 10-year carryback provision of this section applies, except as provided in this paragraph, to any taxpayer who, for a taxable year beginning after September 30, 1979, incurs a product liability loss. Any taxpayer entitled to a 10-year carryback under paragraph (a) of this section in any loss year may elect (at the time and in the manner provided in paragraph (c)(2) of this section) to have the carryback period with respect to the product liability loss determined without regard to the carryback rules provided by paragraph (a) of this section. If the taxpayer so elects, the product liability loss shall not be carried back to the 10th through the 4th taxable years preceding the loss year. In such case, the product liability loss shall be carried back or carried over as provided by section 172(b) (except subparagraph (1)(I) thereof) and the regulations thereunder.

(2) *Time and manner of making election.* An election by any taxpayer entitled to the 10-year carryback for the product liability loss to have the carryback with respect to such loss determined without regard to the 10-year carryback provision of paragraph (a) of this section must be made by attaching to the taxpayer's tax return (filed within the time prescribed by law, including extensions of time) for the taxable year in which such product liability loss is sustained, a statement containing the information required by paragraph (c)(3) of this section. Such election, once made for any taxable year, shall be irrevocable after the due date (including extensions of time) of the taxpayer's tax return for that taxable year.

(3) *Information required.* In the case of a statement filed after April 25, 1983, the statement referred to in paragraph (c)(2) of this section shall contain the following information:

(i) The name, address, and taxpayer identifying number of the taxpayer; and

(ii) A statement that the taxpayer elects under section 172(j)(3) not to have section 172(b)(1)(I) apply.

(4) *Relationship with section 172(b)(3)(C) election.* If a taxpayer sustains during the taxable year both a net operating loss not attributable to

product liability and a product liability loss (as defined in section 172(j)(1) and paragraph (b)(1) of this section), an election pursuant to section 172(b)(3)(C) (relating to election to relinquish the entire carryback period) does not preclude the product liability loss from being carried back 10 years under section 172(b)(1)(I) and paragraph (a)(1) of this section.

[T.D. 8096, 51 FR 30482, Aug. 27, 1986]

§ 1.173–1 Circulation expenditures.

(a) *Allowance of deduction.* Section 173 provides for the deduction from gross income of all expenditures to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical, subject to the following limitations:

(1) No deduction shall be allowed for expenditures for the purchase of land or depreciable property or for the acquisition of circulation through the purchase of any part of the business of another publisher of a newspaper, magazine, or other periodical;

(2) The deduction shall be allowed only to the publisher making the circulation expenditures; and

(3) The deduction shall be allowed only for the taxable year in which such expenditures are paid or incurred.

Subject to the provisions of paragraph (c) of this section, the deduction permitted under section 173 and this paragraph shall be allowed without regard to the method of accounting used by the taxpayer and notwithstanding the provisions of section 263 and the regulations thereunder, relating to capital expenditures.

(b) *Deferred expenditures.* Notwithstanding the provisions of paragraph (a)(3) of this section, expenditures paid or incurred in a taxable year subject to the Internal Revenue Code of 1939 which are deferrable pursuant to I.T. 3369 (C.B. 1940–1, 46), as modified by Rev. Rul. 57–87 (C.B. 1957–1, 507) may be deducted in the taxable year subject to the Internal Revenue Code of 1954 to which so deferred.

(c) *Election to capitalize.* (1) A taxpayer entitled to the deduction for circulation expenditures provided in section 173 and paragraph (a) of this section may, in lieu of taking such deduction, elect to capitalize the portion of such circulation expenditures which is properly chargeable to capital account. As a general rule, expenditures normally made from year to year in an effort to maintain circulation are not properly chargeable to capital account; conversely, expenditures made in an effort to establish or to increase circulation are properly chargeable to capital account. For example, if a newspaper normally employs five persons to obtain renewals of subscriptions by telephone, the expenditures in connection therewith would not be properly chargeable to capital account. However, if such newspaper, in a special effort to increase its circulation, hires for a limited period 20 additional employees to obtain new subscriptions by means of telephone calls to the general public, the expenditures in connection therewith would be properly chargeable to capital account. If an election is made by a taxpayer to treat any portion of his circulation expenditures as chargeable to capital account, the election must apply to all such expenditures which are properly so chargeable. In such case, no deduction shall be allowed under section 173 for any such expenditures. In particular cases, the extent to which any deductions attributable to the amortization of capital expenditures are allowed may be determined under sections 162, 263, and 461.

(2) A taxpayer may make the election referred to in subparagraph (1) of this paragraph by attaching a statement to his return for the first taxable year to which the election is applicable. Once an election is made, the taxpayer must continue in subsequent taxable years to charge to capital account all circulation expenditures properly so chargeable, unless the Commissioner, on application made to him in writing by the taxpayer, permits a revocation of such election for any subsequent taxable year or years. Permission to revoke such election may be granted subject to such conditions as the Commissioner deems necessary.

(3) Elections filed under section 23(bb) of the Internal Revenue Code of 1939 shall be given the same effect as if they were filed under section 173. (See section 7807(b)(2).)

§ 1.174–1 Research and experimental expenditures; in general.

Section 174 provides two methods for treating research or experimental expenditures paid or incurred by the taxpayer in connection with his trade or business. These expenditures may be treated as expenses not chargeable to capital account and deducted in the year in which they are paid or incurred (see § 1.174–3), or they may be deferred and amortized (see § 1.174–4). Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under section 174 must be charged to capital account. The expenditures to which section 174 applies may relate either to a general research program or to a particular project. See § 1.174–2 for the definition of research and experimental expenditures. The term *paid or incurred,* as used in section 174 and in §§ 1.174–1 to 1.174–4, inclusive, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25).

§ 1.174–2 Definition of research and experimental expenditures.

(a) *In general.* (1) *Research or experimental expenditures defined.* The term *research or experimental expenditures,* as used in section 174, means expenditures incurred in connection with the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense. The term generally includes all such costs incident to the development or improvement of a product. The term includes the costs of obtaining a patent, such as attorneys' fees expended in making and perfecting a patent application. Expenditures represent research and development costs in the experimental or laboratory sense if they are for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists if the information available to the taxpayer does not establish the capability or method for developing or improving the product or the appropriate design of the product. Whether expenditures qualify as research or experimental expenditures depends on the nature of the activity to which the expenditures relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. The ultimate success, failure, sale, or use of the product is not relevant to a determination of eligibility under section 174. Costs may be eligible under section 174 if paid or incurred after production begins but before uncertainty concerning the development or improvement of the product is eliminated.

(2) *Production costs.* Except as provided in paragraph (a)(5) of this section (the rule concerning the application of section 174 to components of a product), costs paid or incurred in the production of a product after the elimination of uncertainty concerning the development or improvement of the product are not eligible under section 174.

(3) *Product defined.* For purposes of this section, the term *product* includes any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license.

(4) *Pilot model defined.* For purposes of this section, the term *pilot model* means any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product. The term includes a fully-functional representation or model of the product or, to the extent paragraph (a)(5) of this section applies, a component of the product.

(5) *Application of section 174 to components of a product.* If the requirements of paragraph (a)(1) of this section are not met at the level of a product (as defined in paragraph (a)(3) of this section), then whether expenditures represent research and development costs is determined at the level of the component or subcomponent of the product. The presence of uncertainty concerning the development or improvement of certain components of a product does not necessarily indicate the presence of uncertainty concerning the development or improvement of other

components of the product or the product as a whole. The rule in this paragraph (a)(5) is not itself applied as a reason to exclude research or experimental expenditures from section 174 eligibility.

(6) *Research or experimental expenditures—exclusions.* The term *research or experimental expenditures* does not include expenditures for—

(i) The ordinary testing or inspection of materials or products for quality control (quality control testing);

(ii) Efficiency surveys;

(iii) Management studies;

(iv) Consumer surveys;

(v) Advertising or promotions;

(vi) The acquisition of another's patent, model, production or process; or

(vii) Research in connection with literary, historical, or similar projects.

(7) *Quality control testing.* For purposes of paragraph (a)(6)(i) of this section, testing or inspection to determine whether particular units of materials or products conform to specified parameters is quality control testing. However, quality control testing does not include testing to determine if the design of the product is appropriate.

(8) *Expenditures for literary, historical, or similar research—cross reference.* See section 263A and the regulations thereunder for cost capitalization rules which apply to expenditures paid or incurred for research in connection with literary, historical, or similar projects involving the production of property, including the production of films, sound recordings, video tapes, books, or similar properties.

(9) *Research or experimental expenditures limited to reasonable amounts.* Section 174 applies to a research or experimental expenditure only to the extent that the amount of the expenditure is reasonable under the circumstances. In general, the amount of an expenditure for research or experimental activities is reasonable if the amount would ordinarily be paid for like activities by like enterprises under like circumstances. Amounts supposedly paid for research that are not reasonable under the circumstances may be characterized as disguised dividends, gifts, loans, or similar payments. The reasonableness requirement of this paragraph (a)(9) does not apply to the reasonableness of the type or nature of the activities themselves.

(10) *Amounts paid to others for research or experimentation.* The provisions of this section apply not only to costs paid or incurred by the taxpayer for research or experimentation undertaken directly by him but also to expenditures paid or incurred for research or experimentation carried on in his behalf by another person or organization (such as a research institute, foundation, engineering company, or similar contractor). However, any expenditures for research or experimentation carried on in the taxpayer's behalf by another person are not expenditures to which section 174 relates, to the extent that they represent expenditures for the acquisition or improvement of land or depreciable property, used in connection with the research or experimentation, to which the taxpayer acquires rights of ownership.

(11) *Examples.* The following examples illustrate the application of this paragraph (a).

Example 1. Amounts paid to others for research or experimentation allowed as a deduction. A engages B to undertake research and experimental work in order to create a particular product. B will be paid annually a fixed sum plus an amount equivalent to his actual expenditures. In 1957, A pays to B in respect of the project the sum of $150,000 of which $25,000 represents an addition to B's laboratory and the balance represents charges for research and experimentation on the project. It is agreed between the parties that A will absorb the entire cost of this addition to B's laboratory which will be retained by B. A may treat the entire $150,000 as expenditures under section 174.

Example 2. Amounts paid to others not allowable as a deduction. S Corporation, a manufacturer of explosives, contracts with the T research organization to attempt through research and experimentation the creation of a new process for making certain explosives. Because of the danger involved in such an undertaking, T is compelled to acquire an isolated tract of land on which to conduct the research and experimentation. It is agreed that upon completion of the project T will transfer this tract, including any improvements thereon, to S. Section 174 does not apply to the amount paid to T representing the costs of the tract of land and improvements.

Example 3. Pilot model. U is engaged in the manufacture and sale of custom machines. U contracts to design and produce a machine to meet a customer's specifications. Because

U has never designed a machine with these specifications, U is uncertain regarding the appropriate design of the machine, and particularly whether features desired by the customer can be designed and integrated into a functional machine. U incurs a total of $31,000 on the project. Of the $31,000, U incurs $10,000 of costs on materials and labor to produce a model that is used to evaluate and resolve the uncertainty concerning the appropriate design. U also incurs $1,000 of costs using the model to test whether certain features can be integrated into the design of the machine. This $11,000 of costs represents research and development costs in the experimental or laboratory sense. After uncertainty is eliminated, U incurs $20,000 to produce the machine for sale to the customer based on the appropriate design. The model produced and used to evaluate and resolve uncertainty is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $10,000 incurred to produce the model and the $1,000 incurred on design testing activities qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $20,000 that U incurred to produce the machine for sale to the customer based on the appropriate design. See paragraph (a)(2) of this section (relating to production costs).

Example 4. Product component redesign. Assume the same facts as *Example 3,* except that during a quality control test of the machine, a component of the machine fails to function due to the component's inappropriate design. U incurs an additional $8,000 (including design retesting) to reconfigure the component's design. The $8,000 of costs represents research and development costs in the experimental or laboratory sense. After the elimination of uncertainty regarding the appropriate design of the component, U incurs an additional $2,000 on its production. The reconfigured component produced and used to evaluate and resolve uncertainty with respect to the component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, in addition to the $11,000 of research and experimental expenditures previously incurred, the $8,000 incurred on design activities to establish the appropriate design of the component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the additional $2,000 that U incurred for the production after the elimination of uncertainty of the re-designed component based on the appropriate design or to the $20,000 previously incurred to produce the machine. See paragraph (a)(2) of this section (relating to production costs).

Example 5. Multiple pilot models. V is a manufacturer that designs a new product. V incurs $5,000 to produce a number of models of the product that are to be used in testing the appropriate design before the product is mass-produced for sale. The $5,000 of costs represents research and development costs in the experimental or laboratory sense. Multiple models are necessary to test the design in a variety of different environments (exposure to extreme heat, exposure to extreme cold, submersion, and vibration). In some cases, V uses more than one model to test in a particular environment. Upon completion of several years of testing, V enters into a contract to sell one of the models to a customer and uses another model in its trade or business. The remaining models were rendered inoperable as a result of the testing process. Because V produced the models to resolve uncertainty regarding the appropriate design of the product, the models are pilot models under paragraph (a)(4) of this section. Therefore, the $5,000 that V incurred in producing the models qualifies as research or experimental expenditures under section 174. See also paragraph (a)(1) of this section (ultimate use is not relevant).

Example 6. Development of a new component; pilot model. W wants to improve a machine for use in its trade or business and incurs $20,000 to develop a new component for the machine. The $20,000 is incurred for engineering labor and materials to produce a model of the new component that is used to eliminate uncertainty regarding the development of the new component for the machine. The $20,000 of costs represents research and experimental costs in the experimental or laboratory sense. After W completes its research and experimentation on the new component, W incurs $10,000 for materials and labor to produce the component and incorporate it into the machine. The model produced and used to evaluate and resolve uncertainty with respect to the new component is a pilot model within the meaning of paragraph (a)(4) of this section. Therefore, the $20,000 incurred to produce the model and eliminate uncertainty regarding the development of the new component qualifies as research or experimental expenditures under section 174. However, section 174 does not apply to the $10,000 of production costs of the component because those costs were not incurred for research or experimentation. See paragraph (a)(2) of this section (relating to production costs).

Example 7. Disposition of a pilot model. X is a manufacturer of aircraft. X is researching and developing a new, experimental aircraft that can take off and land vertically. To evaluate and resolve uncertainty during the development or improvement of the product and test the appropriate design of the experimental aircraft, X produces a working aircraft at a cost of $5,000,000. The $5,000,000 of costs represents research and development costs in the experimental or laboratory sense. In a later year, X sells the aircraft. Because X produced the aircraft to resolve uncertainty regarding the appropriate design of the product during the development of the experimental aircraft, the aircraft is a pilot model under paragraph (a)(4) of this section. Therefore, the $5,000,000 of costs that X incurred in producing the aircraft qualifies as research or experimental expenditures under section 174. Further, it would not matter if X sold the pilot model or incorporated it in its own business as a demonstration model. See paragraph (a)(1) of this section (ultimate use is not relevant).

Example 8. Development of new component; pilot model. Y is a manufacturer of aircraft engines. Y is researching and developing a new type of compressor blade, a component of an aircraft engine, to improve the performance of an existing aircraft engine design that Y already manufactures and sells. To test the appropriate design of the new compressor blade and evaluate the impact of fatigue on the compressor blade design, Y produces and installs the compressor blade on an aircraft engine held by Y in its inventory. The costs of producing and installing the compressor blade component that Y incurred represent research and development costs in the experimental or laboratory sense. Because Y produced the compressor blade component to resolve uncertainty regarding the appropriate design of the component, the component is a pilot model under paragraph (a)(4) of this section. Therefore, the costs that Y incurred to produce and install the component qualify as research or experimental expenditures under section 174. See paragraph (a)(5) of this section (regarding the application of section 174 to components of a product). However, section 174 does not apply to Y's costs of producing the aircraft engine on which the component was installed. See paragraph (a)(2) of this section (relating to production costs).

Example 9. Variant product. T is a fuselage manufacturer for commercial and military aircraft. T is modifying one of its existing fuselage products, Class 20XX–1, to enable it to carry a larger passenger and cargo load. T modifies the Class 20XX–1 design by extending its length by 40 feet. T incurs $1,000,000 to develop and evaluate different designs to resolve uncertainty with respect to the appropriate design of the new fuselage class, Class 20XX–2. The $1,000,000 of costs represents research and development costs in the experimental or laboratory sense. Although Class 20XX–2, is a variant of Class 20XX–1, Class 20XX–2 is a new product because the information available to T as a result of T's development of Class 20XX–1 does not resolve uncertainty with respect to T's development of Class 20XX–2. Therefore, the $1,000,000 of costs that T incurred to develop and evaluate the Class 20XX–2 qualifies as research or experimental expenditures under section 174. Paragraph (a)(5) of this section does not apply, as the requirements of paragraph (a)(1) of this section are met with respect to the entire product.

Example 10. New process development. Z is a wine producer. Z is researching and developing a new wine production process that involves the use of a different method of crushing the wine grapes. In order to test the effectiveness of the new method of crushing wine grapes, Z incurs $2,000 in labor and materials to conduct the test on this part of the new manufacturing process. The $2,000 of costs represents research and development costs in the experimental or laboratory sense. Therefore, the $2,000 incurred qualifies as research or experimental expenditures under section 174 because it is a cost incident to the development or improvement of a component of a process.

(b) *Certain expenditures with respect to land and other property.* (1)*Land and other property.* Expenditures by the taxpayer for the acquisition or improvement of land, or for the acquisition or improvement of property which is subject to an allowance for depreciation under section 167 or depletion under section 611, are not deductible under section 174, irrespective of the fact that the property or improvements may be used by the taxpayer in connection with research or experimentation. However, allow- ances for depreciation or depletion of property are considered as research or experimental expenditures, for purposes of section 174, to the extent that the property to which the allowances relate is used in connection with research or experimentation. If any part of the cost of acquisition or improvement of depreciable property is attributable to research or experimentation (whether made by the taxpayer or another), see subparagraphs (2), (3), and (4) of this paragraph.

(2) *Expenditure resulting in depreciable property.* Expenditures for research or experimentation which result, as an end product of the research or experimentation, in depreciable property to be used in the taxpayer's trade or business may, subject to the limitations of subparagraph (4) of this paragraph, be allowable as a current expense deduction under section 174(a). Such expenditures cannot be amortized under section 174(b) except to the extent provided in paragraph (a)(4) of §1.174–4.

(3) *Amounts paid to others for research or experimentation resulting in depreciable property.* If expenditures for research or experimentation are incurred

in connection with the construction or manufacture of depreciable property by another, they are deductible under section 174(a) only if made upon the taxpayer's order and at his risk. No deduction will be allowed (i) if the taxpayer purchases another's product under a performance guarantee (whether express, implied, or imposed by local law) unless the guarantee is limited, to engineering specifications or otherwise, in such a way that economic utility is not taken into account; or (ii) for any part of the purchase price of a product in regular production. For example, if a taxpayer orders a specially-built automatic milling machine under a guarantee that the machine will be capable of producing a given number of units per hour, no portion of the expenditure is deductible since none of it is made at the taxpayer's risk. Similarly, no deductible expense is incurred if a taxpayer enters into a contract for the construction of a new type of chemical processing plant under a turn-key contract guaranteeing a given annual production and a given consumption of raw material and fuel per unit. On the other hand, if the contract contained no guarantee of quality of production and of quantity of units in relation to consumption of raw material and fuel, and if real doubt existed as to the capabilities of the process, expenses for research or experimentation under the contract are at the taxpayer's risk and are deductible under section 174(a). However, see subparagraph (4) of this paragraph.

(4) *Deductions limited to amounts expended for research or experimentation.* The deductions referred to in paragraphs (b)(2) and (3) of this section for expenditures in connection with the acquisition or production of depreciable property to be used in the taxpayer's trade or business are limited to amounts expended for research or experimentation within the meaning of section 174 and paragraph (a) of this section.

(5) *Examples.* The following examples illustrate the application of paragraph (b) of this section.

Example 1. Amounts paid to others for research or experimentation resulting in depreciable property. X is a tool manufacturer. X has developed a new tool design, and orders a specially-built machine from Y to produce X's new tool. The machine is built upon X's order and at X's risk, and Y does not provide a guarantee of economic utility. There is uncertainty regarding the appropriate design of the machine. Under X's contract with Y, X pays $15,000 for Y's engineering and design labor, $5,000 for materials and supplies used to develop the appropriate design of the machine, and $10,000 for Y's machine production materials and labor. The $15,000 of engineering and design labor costs and the $5,000 of materials and supplies costs represent research and development costs in the experimental or laboratory sense. Therefore, the $15,000 X pays Y for Y's engineering and design labor and the $5,000 for materials and supplies used to develop the appropriate design of the machine are for research or experimentation under section 174. However, section 174 does not apply to the $10,000 of production costs of the machine because those costs were not incurred for research or experimentation. See paragraph (a)(2) of this section (relating to production costs) and paragraph (b)(4) of this section (limiting deduction to amounts expended for research or experimentation).

Example 2. Expenditures with respect to other property. Z is an aircraft manufacturer. Z incurs $5,000,000 to construct a new test bed that will be used in the development and improvement of Z's aircraft. No portion of Z's $5,000,000 of costs to construct the new test bed represent research and development costs in the experimental or laboratory sense to develop or improve the test bed. Because no portion of the costs to construct the new test bed were incurred for research or experimentation, the $5,000,000 will be considered an amount paid or incurred in the production of depreciable property to be used in the taxpayer's trade or business that are not allowable under section 174. However, the allowances for depreciation of the test bed are considered research and experimental expenditures of other products, for purposes of section 174, to the extent the test bed is used in connection with research or experimentation of other products. See paragraph (b)(1) of this section (depreciation allowances may be considered research or experimental expenditures).

Example 3. Expenditure resulting in depreciable property. Assume the same facts as *Example 2,* except that $50,000 of the costs of the test bed relates to costs to resolve uncertainties regarding the new test bed design. The $50,000 of costs represents research and development costs in the experimental or laboratory sense. Because $50,000 of Z's costs to construct the new test bed was incurred for research and experimentation, the costs qualify as research or experimental expenditures under section 174. Paragraph (b)(2) of this section applies to $50,000 of Z's costs for the test bed because they are expenditures for research or experimentation that result in depreciable property to be used in the taxpayer's trade or business. Z's remaining $4,950,000 of costs is not allowable under section 174 because these costs were not incurred for research or experimentation.

(c) *Exploration expenditures.* The provisions of section 174 are not applicable to any expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore, oil, gas or other mineral. See sections 617 and 263.

(d) *Effective/applicability date.* The eighth and ninth sentences of §1.174–2(a)(1); §1.174–2(a)(2); §1.174–2(a)(4); §1.174–2(a)(5); §1.174–2(a)(11) *Example 3* through *Example 10;* §1.174–2(b)(4); and §1.174–2(b)(5) apply to taxable years ending on or after July 21, 2014. Taxpayers may apply the provisions enumerated in the preceding sentence to taxable years for which the limitations for assessment of tax has not expired.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8562, 59 FR 50160, Oct. 3, 1994; T.D. 9680, 79 FR 42195, July 21, 2014]

§ 1.174–3 Treatment as expenses.

(a) *In general.* Research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with his trade or business are deductible as expenses, and are not chargeable to capital account, if the taxpayer adopts the method provided in section 174(a). See paragraph (b) of this section. If adopted, the method shall apply to all research and experimental expenditures paid or incurred in the taxable year of adoption and all subsequent taxable years, unless a different method is authorized by the Commissioner under section 174(a)(3) with respect to part or all of the expenditures. See paragraph (b)(3) of this section. Thus, if a change to the deferred expense method under section 174(b) is authorized by the Commissioner with respect to research or experimental expenditures attributable to a particular project or projects, the taxpayer, for the taxable year of the change and for subsequent taxable years, must apply the deferred expense method to all such expenditures paid or incurred during any of those taxable years in connection with the particular project or projects, even though all other research and experimental expenditures are required to be deducted as current expenses under this section. In no event will the taxpayer be permitted to adopt the method described in this section as to part of the expenditures relative to a particular project and adopt for the same taxable year a different method of treating the balance of the expenditures relating to the same project.

(b) *Adoption and change of method*—(1) *Adoption without consent.* The method described in this section may be adopted for any taxable year beginning after December 31, 1953, and ending after August 16, 1954. The consent of the Commissioner is not required if the taxpayer adopts the method for the first such taxable year in which he pays or incurs research or experimental expenditures. The taxpayer may do so by claiming in his income tax return for such year a deduction for his research or experimental expenditures. If the taxpayer fails to adopt the method for the first taxable year in which he incurs such expenditures, he cannot do so in subsequent taxable years unless he obtains the consent of the Commissioner under section 174(a)(2)(B) and subparagraph (2) of this paragraph. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(2) *Adoption with consent.* A taxpayer may, with the consent of the Commissioner, adopt at any time the method provided in section 174(a). The method adopted in this manner shall be applicable only to expenditures paid or incurred during the taxable year for which the request is made and in subsequent taxable years. A request to adopt this method shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The request shall set forth the name and address of the taxpayer, the first taxable year for which the adoption of the method is requested, and a description of the project or projects with respect to which research or experimental expenditures are to be, or have already been, paid or incurred. The request shall be signed by the taxpayer (or his duly authorized representative) and shall be filed not later than the last day of the first taxable year for which

the adoption of the method is requested. See, however, subparagraph (4) of this paragraph, relating to extensions of time.

(3) *Change of method.* An application for permission to change to a different method of treating research or experimental expenditures shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the last day of the first taxable year for which the change in method is to apply. See, however, subparagraph (4) of this paragraph, relating to extensions of time. The application shall:

(i) State the first year to which the requested change is to be applicable;

(ii) State whether the change is to apply to all research or experimental expenditures paid or incurred by the taxpayer, or only to expenditures attributable to a particular project or projects;

(iii) Include such information as will identify the project or projects to which the change is applicable;

(iv) Indicate the number of months (not less than 60) selected for amortization of the expenditures, if any, which are to be treated as deferred expenses under section 174(b);

(v) State that, upon approval of the application, the taxpayer will make an accounting segregation on his books and records of the research or experimental expenditures to which the change in method is to apply; and

(vi) State the reasons for the change.

If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting permission to his income tax return for the first taxable year in which the different method is effective.

(4) *Special rules.* If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 174(a) is applicable falls before January 2, 1958, consent is hereby given for the taxpayer to adopt the expense method or to change from the expense method to a different method. In the case of a change from the expense method to a different method, the taxpayer, on or before January 2, 1958, must submit to the district director for the internal revenue district in which the return was filed the information required by subparagraph (3) of this paragraph. For any taxable year for which the expense method or a different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958, if such return is necessary.

§ 1.174–4 Treatment as deferred expenses.

(a) *In general.* (1) If a taxpayer has not adopted the method provided in section 174(a) of treating research or experimental expenditures paid or incurred by him in connection with his trade or business as currently deductible expenses, he may, for any taxable year beginning after December 31, 1953, elect to treat such expenditures as deferred expenses under section 174(b), subject to the limitations of subparagraph (2) of this paragraph. If a taxpayer has adopted the method of treating such expenditures as expenses under section 174(a), he may not elect to defer and amortize any such expenditures unless permission to do so is granted under section 174(a)(3). See paragraph (b) of this section.

(2) The election to treat research or experimental expenditures as deferred expenses under section 174(b) applies only to those expenditures which are chargeable to capital account but which are not chargeable to property of a character subject to an allowance for depreciation or depletion under section 167 or 611, respectively. Thus, the election under section 174(b) applies only if the property resulting from the research or experimental expenditures has no determinable useful life. If the property resulting from the expenditures has a determinable useful life, section 174(b) is not applicable, and the capitalized expenditures must be amortized or depreciated over the determinable useful life. Amounts treated as deferred expenses are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property. See section

1016(a)(14). See section 174(c) and paragraph (b)(1) of §1.174–2 for treatment of expenditures for the acquisition or improvement of land or of depreciable or depletable property to be used in connection with the research or experimentation.

(3) Expenditures which are treated as deferred expenses under section 174(b) are allowable as a deduction ratably over a period of not less than 60 consecutive months beginning with the month in which the taxpayer first realizes benefits from the expenditures. The length of the period shall be selected by the taxpayer at the time he makes the election to defer the expenditures. If a taxpayer has two or more separate projects, he may select a different amortization period for each project. In the absence of a showing to the contrary, the taxpayer will be deemed to have begun to realize benefits from the deferred expenditures in the month in which the taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use. See section 1016(a)(14) for adjustments to basis of property for amounts allowed as deductions under section 174(b) and this section. See section 165 and the regulations thereunder for rules relating to the treatment of losses resulting from abandonment.

(4) If expenditures which the taxpayer has elected to defer and deduct ratably over a period of time in accordance with section 174(b) result in the development of depreciable property, deductions for the unrecovered expenditures, beginning with the time the asset becomes depreciable in character, shall be determined under section 167 (relating to depreciation) and the regulations thereunder. For example, for the taxable year 1954, A, who reports his income on the basis of a calendar year, elects to defer and deduct ratably over a period of 60 months research and experimental expenditures made in connection with a particular project. In 1956, the total of the deferred expenditures amounts to $60,000. At that time, A has developed a process which he seeks to patent. On July 1, 1956, A first realized benefits from the marketing of products resulting from this process. Therefore, the expenditures deferred are deductible ratably over the 60-month period beginning with July 1, 1956 (when A first realized benefits from the project). In his return for the year 1956. A deducted $6,000; in 1957, A deducted $12,000 ($1,000 per month). On July 1, 1958, a patent protecting his process is obtained by A. In his return for 1958, A is entitled to a deduction of $6,000, representing the amortizable portion of the deferred expenses attributable to the period prior to July 1, 1958. The balance of the unrecovered expenditures ($60,000 minus $24,000, or $36,000) is to be recovered as a depreciation deduction over the life of the patent commencing with July 1, 1958. Thus, one-half of the annual depreciation deduction based upon the useful life of the patent is also deductible for 1958 (from July 1 to December 31).

(5) The election shall be applicable to all research and experimental expenditures paid or incurred by the taxpayer or, if so limited by the taxpayer's election, to all such expenditures with respect to the particular project, subject to the limitations of subparagraph (2) of this paragraph. The election shall apply for the taxable year for which the election is made and for all subsequent taxable years, unless a change to a different treatment is authorized by the Commissioner under section 174(b)(2). See paragraph (b)(2) of this section. Likewise, the taxpayer shall adhere to the amortization period selected at the time of the election unless a different period of amortization with respect to a part or all of the expenditures is similarly authorized. However, no change in method will be permitted with respect to expenditures paid or incurred before the taxable year to which the change is to apply. In no event will the taxpayer be permitted to treat part of the expenditures with respect to a particular project as deferred expenses under section 174(b) and to adopt a different method of treating the balance of the expenditures relating to the same project for the same taxable year. The election under this section shall not apply to any expenditures paid or incurred before the taxable year for which the taxpayer makes the election.

(b) *Election and change of method*—(1) *Election*. The election under section

174(b) shall be made not later than the time (including extensions) prescribed by law for filing the return for the taxable year for which the method is to be adopted. The election shall be made by attaching a statement to the taxpayer's return for the first taxable year to which the election is applicable. The statement shall be signed by the taxpayer (or his duly authorized representative), and shall:

(i) Set forth the name and address of the taxpayer;

(ii) Designate the first taxable year to which the election is to apply;

(iii) State whether the election is intended to apply to all expenditures within the permissible scope of the election, or only to a particular project or projects, and, if the latter, include such information as will identify the project or projects as to which the election is to apply;

(iv) Set forth the amount of all research or experimental expenditures paid or incurred during the taxable year for which the election is made;

(v) Indicate the number of months (not less than 60) selected for amortization of the deferred expenses for each project; and

(vi) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(2) *Change to a different method or period.* Application for permission to change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Attention: T:R, Washington, DC, 20224. The application shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the end of the first taxable year in which the different method or different amortization period is to be used (unless subparagraph (3) of this paragraph, relating to extensions of time, is applicable). The application shall set forth the following information with regard to the research or experimental expenditures which are being treated under section 174(b) as deferred expenses:

(i) Total amount of research or experimental expenditures attributable to each project;

(ii) Amortization period applicable to each project; and

(iii) Unamortized expenditures attributable to each project at the beginning of the taxable year in which the application is filed.

In addition, the application shall set forth the length of the new period or periods proposed, or the new method of treatment proposed, the reasons for the proposed change, and such information as will identify the project or projects to which the expenditures affected by the change relate. If permission is granted to make the change, the taxpayer shall attach a copy of the letter granting the permission to his income tax return for the first taxable year in which the different method or period is to be effective.

(3) *Special rules.* If the last day prescribed by law for filing a return for any taxable year for which the deferred method provided in section 174(b) has been adopted falls before January 2, 1958, consent is hereby given for the taxpayer to change from such method and adopt a different method of treating research or experimental expenditures, provided that on or before January 2, 1958, he submits to the district director for the district in which the return was filed the information required by subparagraph (2) of this paragraph, relating to a change to a different method or period. For any taxable year for which the different method is adopted pursuant to this subparagraph, an amended return reflecting such method shall be filed on or before January 2, 1958.

(c) *Example.* The application of this section is illustrated by the following example:

Example. N Corporation is engaged in the business of manufacturing chemical products. On January 1, 1955, work is begun on a special research project. N Corporation elects, pursuant to section 174(b), to defer the expenditures relating to the special project and to amortize the expenditures over a period of 72 months beginning with the month in which benefits from the expenditures are first realized. On January 1, 1955, N Corporation also purchased for $57,600 a building having a remaining useful life of 12 years as of the date of purchase and no salvage value at the end of the period. Fifty percent of the building's facilities are to be used in connection with the special research project. During 1955, N Corporation pays or incurs the following expenditures relating to the special research project:

Salaries	$15,000
Heat, light and power	700
Drawings	2,000
Models	6,500
Laboratory materials	8,000
Attorneys' fees	1,400
Depreciation on building attributable to project (50 percent of $4,800 allowable depreciation)	2,400
Total research and development expenditures	36,000

The above expenditures result in a process which is marketable but not patentable and which has no determinable useful life. N Corporation first realizes benefits from the process in January 1956. N Corporation is entitled to deduct the amount of $6,000 ($36,000 × 12 months ÷ 72 months) as deferred expenses under section 174(b) in computing taxable income for 1956.

§ 1.175–1 Soil and water conservation expenditures; in general.

Under section 175, a farmer may deduct his soil or water conservation expenditures which do not give rise to a deduction for depreciation and which are not otherwise deductible. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, he must deduct all such expenditures (subject to the 25-percent limitation) for the current and subsequent taxable years. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate.

§ 1.175–2 Definition of soil and water conservation expenditures.

(a) *Expenditures treated as a deduction.* (1) The method described in section 175 applies to expenditures paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, but only if such expenditures are made in the furtherance of the business of farming. More specifically, a farmer may deduct expenditures made for these purposes which are for (i) the treatment or moving of earth, (ii) the construction, control, and protection of diversion channels, drainage ditches, irrigation ditches, earthen dams, watercourses, outlets, and ponds, (iii) the eradication of brush, and (iv) the planting of windbreaks. Expenditures for the treatment or moving of earth include but are not limited to expenditures for leveling, conditioning, grading, terracing, contour furrowing, and restoration of soil fertility. For rules relating to the allocation of expenditures that benefit both land used in farming and other land of the taxpayer, see § 1.175–7.

(2) The following are examples of soil and water conservation: (i) Constructing terraces, or the like, to detain or control the flow of water, to check soil erosion on sloping land, to intercept runoff, and to divert excess water to protected outlets; (ii) constructing water detention or sediment retention dams to prevent or fill gullies, to retard or reduce run-off of water, or to collect stock water; and (iii) constructing earthen floodways, levies, or dikes, to prevent flood damage to farmland.

(b) *Expenditures not subject to section 175 treatment.* (1) The method described in section 175 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities subject to the allowance for depreciation. Thus, the method does not apply to depreciable nonearthen items such as those made of masonry or concrete (see section 167). For example, expenditures in respect of depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. However, the method applies to expenditures for earthen items which are not subject to a depreciation allowance. For example, expenditures for earthen terraces and dams which are nondepreciable are deductible under section 175. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., for purposes other than soil or water conservation, see section 180 and the regulations thereunder.

(2) The method does not apply to expenses deductible apart from section 175. Adoption of the method is not necessary in order to deduct such expenses in full without limitation. Thus, the method does not apply to interest (deductible under section 163), nor to taxes (deductible under section 164). It does not apply to expenses for the repair of completed soil or water conservation structures, such as costs of annual removal of sediment from a drainage ditch. It does not apply to expenditures paid or incurred primarily to produce an agricultural crop even though they incidentally conserve soil. Thus, the cost of fertilizing (the effectiveness of which does not last beyond one year) used to produce hay is deductible without adoption of the method prescribed in section 175. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., for purposes other than soil or water conservation, see section 180 and the regulations thereunder. However, the method would apply to expenses incurred to produce vegetation primarily to conserve soil or water or to prevent erosion. Thus, for example, the method would apply to such expenditures as the cost of dirt moving, lime, fertilizer, seed and planting stock used in gulley stabilization, or in stabilizing severely eroded areas, in order to obtain a soil binding stand of vegetation on raw or infertile land.

(c) *Assessments*. The method applies also to that part of assessments levied by a soil or water conservation or drainage district to reimburse it for its expenditures which, if actually paid or incurred during the taxable year by the taxpayer directly, would be deductible under section 175. Depending upon the farmer's method of accounting, the time when the farmer pays or incurs the assessment, and not the time when the expenditures are paid or incurred by the district, controls the time the deduction must be taken. The provisions of this paragraph may be illustrated by the following example:

Example. In 1955 a soil and water conservation district levies an assessment of $700 upon a farmer on the cash method of accounting. The assessment is to reimburse the district for its expenditures in 1954. The farmer's share of such expenditures is as follows: $400 for digging drainage ditches for soil conservation and $300 for assets subject to the allowance for depreciation. If the farmer pays the assessment in 1955 and has adopted the method of treating expenditures for soil or water conservation as current expenses under section 175, he may deduct in 1955 the $400 attributable to the digging of drainage ditches as a soil conservation expenditure subject to the 25-percent limitation.

(74 Stat. 1001; 26 U.S.C. 180)

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6548, 26 FR 1487, Feb. 22, 1961; T.D. 7740, 45 FR 78634, Nov. 26, 1980]

§ 1.175–3 Definition of "the business of farming."

The method described in section 175 is available only to a taxpayer engaged in "the business of farming". A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the business of farming. For the purpose of this section, the term *farm* is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised, as opposed to merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in "the business of farming" if he is a member of a partnership engaged in the business of farming. See paragraphs (a)(8)(i) and (c)(1)(iv) of § 1.702–1.

[T.D. 6649, 28 FR 3762, Apr. 18, 1963]

§ 1.175–4 Definition of "land used in farming."

(a) *Requirements.* For purposes of section 175, the term *land used in farming* means land which is used in the business of farming and which meets both of the following requirements:

(1) The land must be used for the production of crops, fruits, or other agricultural products, including fish, or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. Land used for the sustenance of livestock includes land used for grazing such livestock.

(2) The land must be or have been so used either by the taxpayer or his tenant at some time before or at the same time as, the taxpayer makes the expenditures for soil or water conservation or for the prevention of the erosion of land. The taxpayer will be considered to have used the land in farming before making such expenditure if he or his tenant has employed the land in a farming use in the past. If the expenditures are made by the taxpayer in respect of land newly acquired from one who immediately prior to the acquisition was using it in farming, the taxpayer will be considered to be using the land in farming at the time that such expenditures are made, if the use which is made by the taxpayer of the land from the time of its acquisition by him is substantially a continuation of its use in farming, whether for the same farming use as that of the taxpayer's predecessor or for one of the other uses specified in paragraph (a)(1) of this section.

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

Example 1. A purchases an operating farm from B in the autumn after B has harvested his crops. Prior to spring plowing and planting when the land is idle because of the season, A makes certain soil and water conservation expenditures on this farm. At the time such expenditures are made the land is considered to be used by A in farming, and A may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

Example 2. C acquires uncultivated land, not previously used in farming, which he intends to develop for farming. Prior to putting this land into production it is necessary for C to clear brush, construct earthen terraces and ponds, and make other soil and water conservation expenditures. The land is not used in farming at the same time that such expenditures are made. Therefore, C may not deduct such expenditures under section 175.

Example 3. D acquires several tracts of land from persons who had used such land immediately prior to D's acquisition for grazing cattle. D intends to use the land for growing grapes. In order to make the land suitable for this use, D constructs earthen terraces, builds drainage ditches and irrigation ditches, extensively treats the soil, and makes other soil and water conservation expenditures. The land is considered to be used in farming by D at the time he makes such expenditures, even though it is being prepared for a different type of farming activity than that engaged in by D's predecessors. Therefore, D may deduct such expenditures under section 175, subject to the other requisite conditions of such section.

(c) *Cross reference.* For rules relating to the allocation of expenditures that benefit both land used in farming and other land of the taxpayer, see § 1.175–7.

[T.D. 7740, 45 FR 78634, Nov. 26, 1980]

§ 1.175–5 Percentage limitation and carryover.

(a) *The limitation*—(1) *General rule.* The amount of soil and water conservation expenditures which the taxpayer may deduct under section 175 in any one taxable year is limited to 25 percent of his "gross income from farming".

(2) *Definition of "gross income from farming."* For the purpose of section 175, the term *gross income from farming* means the gross income of the taxpayer, derived in "the business of farming" as defined in § 1.175–3, from the production of crops, fruits, or other agricultural products, including fish, or from livestock (including livestock held for draft, breeding, or dairy purposes). It includes such income from land used in farming other than that upon which expenditures are made for soil or water conservation or for the prevention of erosion of land. It does not include gains from sales of assets such as farm machinery or gains from

the disposition of land. A taxpayer shall compute his ''gross income from farming'' in accordance with his accounting method used in determining gross income. (See the regulations under section 61 relating to accounting methods used by farmers in determining gross income.) The provisions of this subparagraph may be illustrated by the following example:

Example. A, who uses the cash receipts and disbursements method of accounting, includes in his ''gross income from farming'' for purposes of determining the 25-percent limitation the following items:

Proceeds from sale of his 1955 yield of corn	$10,000
Gain from disposition of old breeding cows replaced by younger cows	500
Total gross income from farming	10,500

A must exclude from ''gross income from farming'' the following items which are included in his gross income:

Gain from sale of tractor	$100
Gain from sale of 40 acres of taxpayer's farm	8,000
Interest on loan to neighboring farmer	100

(3) *Deduction qualifies for net operating loss deduction.* Any amount allowed as a deduction under section 175, either for the year in which the expenditure is paid or incurred or for the year to which it is carried, is taken into account in computing a net operating loss for such taxable year. If a deduction for soil or water conservation expenditures has been taken into account in computing a net operating loss carryback or carryover, it shall not be considered a soil or water conservation expenditure for the year to which the loss is carried, and therefore, is not subject to the 25-percent limitation for that year. The provisions of this subparagraph may be illustrated by the following example:

Example. Assume that in 1956 A has gross income from farming of $4,000, soil and water conservation expenditures of $1,600 and deductible farm expenses of $3,500. Of the soil and water conservation expenditures $1,000 is deductible in 1956. The $600 in excess of 25 percent of A's gross income from farming is carried over into 1957. Assuming that A has no other income, his deductions of $4,500 ($1,000 plus $3,500) exceed his gross income of $4,000 by $500. This $500 will constitute a net operating loss which he must carry back two years and carry forward five years, until it has offset $500 of taxable income. No part of this $500 net operating loss carryback or carryover will be taken into account in determining the amount of soil and water conservation expenditures in the years to which it is carried.

(b) *Carryover of expenditures in excess of deduction.* The deduction for soil and water conservation expenditures in any one taxable year is limited to 25 percent of the taxpayer's gross income from farming. The taxpayer may carry over the excess of such expenditures over 25 percent of his gross income from farming into his next taxable year, and, if not deductible in that year, into the next year, and so on without limit as to time. In determining the deductible amount of such expenditures for any taxable year, the actual expenditures of that year shall be added to any such expenditures carried over from prior years, before applying the 25-percent limitation. Any such expenditures in excess of the deductible amount may be carried over during the taxpayer's entire existence. For this purpose in a farm partnership, since the 25-percent limitation is applied to each partner, not the partnership, the carryover may be carried forward during the life of the partner. The provisions of this paragraph may be illustrated by the following example:

Example. Assume the expenditures and income shown in the following table:

Year	Deductible soil and water conservation expenditures		Total	25 percent of gross income from farming	Excess to be carried forward
	Paid or incurred during taxable year	Carried forward from prior year			
1954	$900	None	$900	$800	$100
1955	1,000	$100	1,100	900	200
1956	None	200	200	1,000	None

The deduction for 1954 is limited to $800. The remainder, $100 ($900 minus $800), not being deductible for 1954, is a carryover to 1955. For

1955, accordingly, the total of the expenditures to be taken into account is $1,100 (the $100 carryover and the $1,000 actually paid in that year). The deduction for 1955 is limited to $900, and the remainder of the $1,100 total, or $200, is a carryover to 1956. The deduction for 1956 consists solely of this carryover of $200. Since the total expenditures, actual and carried-over, for 1956 are less than 25 percent of gross income from farming, there is no carryover into 1957.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6649, 28 FR 3762, Apr. 18, 1963]

§ 1.175–6 Adoption or change of method.

(a) *Adoption with consent.* A taxpayer may, without consent, adopt the method of treating expenditures for soil or water conservation as expenses for the first taxable year:

(1) Which begins after December 31, 1953, and ends after August 16, 1954, and

(2) For which soil or water conservation expenditures described in section 175(a) are paid or incurred.

Such adoption shall be made by claiming the deduction on his income tax return. For a taxable year ending prior to May 31, 1957, the adoption of the method described in section 175 shall be made by claiming the deduction on such return for that year, or by claiming the deduction on an amended return filed for that year on or before August 30, 1957.

(b) *Adoption with consent.* A taxpayer may adopt the method of treating soil and water conservation expenditures as provided by section 175 for any taxable year to which the section is applicable if consent is obtained from the district director for the internal revenue district in which the taxpayer's return is required to be filed.

(c) *Change of method.* A taxpayer who has adopted the method of treating expenditures for soil or water conservation, as provided by section 175, may change from this method and capitalize such expenditures made after the effective date of the change, if he obtains the consent of the district director for the internal revenue district in which his return is required to be filed.

(d) *Request for consent to adopt or change method.* Where the consent of the district director is required under paragraph (b) or (c) of this section, the request for his consent shall be in writing, signed by the taxpayer or his authorized representative, and shall be filed not later than the date prescribed by law for filing the income tax return for the first taxable year to which the adoption of, or change of, method is to apply, or not later than August 20, 1957, following their adoption, whichever is later. The request shall:

(1) Set forth the name and address of the taxpayer;

(2) Designate the first taxable year to which the method or change of method is to apply;

(3) State whether the method or change of method is intended to apply to all expenditures within the permissible scope of section 175, or only to a particular project or farm and, if the latter, include such information as will identify the project or farm as to which the method or change of method is to apply;

(4) Set forth the amount of all soil and water conservation expenditures paid or incurred during the first taxable year for which the method or change of method is to apply; and

(5) State that the taxpayer will make an accounting segregation in his books and records of the expenditures to which the election relates.

(e) *Scope of method.* Except with the consent of the district director as provided in paragraph (b) or (c) of this section, the taxpayer's method of treating soil and water conservation expenditures described in section 175 shall apply to all such expenditures for the taxable year of adoption and all subsequent taxable years. Although a taxpayer may have elected to deduct soil and water conservation expenditures, he may request an authorization to capitalize his soil and water conservation expenditures attributable to a special project or single farm. Similarly, a taxpayer who has not elected to deduct such expenditures may request an authorization to deduct his soil and water conservation expenditures attributable to a special project or single farm. The authorization with respect to the special project or single farm will not affect the method adopted with respect to the taxpayer's regularly incurred soil and water conservation expenditures. No adoption of, or change of, the method under section 175 will be permitted as to expenditures actually paid or incurred before the taxable year to which the method or change of method is to apply. Thus, if a taxpayer adopts such method for 1956, he cannot deduct any part of such expenditures which he capitalized, or should have capitalized, in 1955. Likewise, if a taxpayer who has adopted such method has an unused carryover of such expenditures in excess of the 25-percent limitation, and is granted consent to capitalize soil and water conservation expenditures beginning in 1956, he cannot capitalize any part of the unused carryover. The excess expenditures carried over continue to be deductible to the extent of 25 percent of the taxpayer's gross income from farming. No adjustment to the basis of land shall be made under section 1016 for expenditures to which the method under section 175 applies. For example, A has an unused carryover of soil and water conservation expenditures amounting to $5,000 as of December 31, 1956. On January 1, 1957, A sells his farm and goes out of the business of farming. The unused carryover of $5,000 cannot be added to the basis of the farm for purposes of determining gain or loss on its sale. In 1959, A purchases another farm and resumes the business of farming. In such year, A may deduct the amount of the unused carryover to the extent of 25 percent of his gross income from farming and may carry over any excess to subsequent years.

§ 1.175–7 Allocation of expenditures in certain circumstances.

(a) *General rule.* If at the time the taxpayer paid or incurred expenditures for the purpose of soil or water conservation, or for the prevention of erosion of land, it was reasonable to believe that such expenditures would directly and substantially benefit land of the taxpayer which does not qualify as "land used in farming," as defined in § 1.175–4, as well as land of the taxpayer which does so qualify, then, for purposes of section 175, only a part of the taxpayer's total expenditures is in respect of "land used in farming."

(b) *Method of allocation.* The part of expenditures allocable to "land used in farming" generally equals the amount which bears the same proportion to the total amount of such expenditures as the area of land of the taxpayer used in farming which it was reasonable to believe would be directly and substantially benefited as a result of the expenditures bears to the total area of land of the taxpayer which it was reasonable to believe would be so benefited. If it is established by clear and convincing evidence that, in the light of all the facts and circumstances, another method of allocation is more reasonable than the method provided in the preceding sentence, the taxpayer may allocate the expenditures under that other method. For purposes of this section, the term *land of the taxpayer* means land with respect to which the taxpayer has title, leasehold, or some other substantial interest.

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

Example 1. A owns a 200-acre tract of land, 80 acres of which qualify as "land used in farming." A makes expenditures for the purpose of soil and water conservation which can reasonably be expected to directly and substantially benefit the entire 200-acre tract. In the absence of clear and convincing evidence that a different allocation is more reasonable, A may deduct 40 percent (80/200) of such expenditures under section 175. The same result would obtain if A had made the expenditures after newly acquiring the tract from a person who had used 80 of the 200 acres in farming immediately prior to A's acquisition.

Example 2. Assume the same facts as in *Example 1,* except that A's expenditures for the purpose of soil and water conservation can reasonably be expected to directly and substantially benefit only the 80 acres which qualify as land used in farming; any benefit to the other 120 acres would be minor and incidental. A may deduct all of such expenditures under section 175.

Example 3. Assume the same facts as in *Example 1,* except that A's expenditures for the purpose of soil and water conservation can reasonably be expected to directly and substantially benefit only the 120 acres which do not qualify as land used in farming. A may not deduct any of such expenditures under section 175. The same result would obtain even if A had leased the 200-acre tract to B in the expectation that B would farm the entire tract.

[T.D. 7740, 45 FR 78635, Nov. 26, 1980]

§ 1.178–1 Depreciation or amortization of improvements on leased property and cost of acquiring a lease.

(a) *In general.* Section 178 provides rules for determining the amount of the deduction allowable for any taxable year to a lessee for depreciation or amortization of improvements made on leased property and as amortization of the cost of acquiring a lease. For purposes of section 178 the term *depreciation* means the deduction allowable for exhaustion, wear and tear, or obsolescence under provisions of the Code such as section 167 or 611 and the regulations thereunder and the term *amortization* means the deduction allowable for amortization of buildings or other improvements made on leased property or for amortization of the cost of acquiring a lease under provisions of the Code such as section 162 or 212 and the regulations thereunder. The provisions of section 178 are applicable with respect to costs of acquiring a lease incurred, and improvements begun, after July 28, 1958, other than improvements which, on July 28, 1958, and at all times thereafter, the lessee was under a binding legal obligation to make.

(b) *Determination of amount of deduction.* (1) In determining the amount of the deduction allowable to a lessee (other than a lessee who is related to the lessor within the meaning of § 1.178–2) for any taxable year for depreciation or amortization of improvements made on leased property, or for amortization in respect of the cost of acquiring a lease, the term of the lease shall, except as provided in subparagraph (2) of this paragraph, be treated as including all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee (whether or not specifically provided for in the lease) if:

(i) In the case of any building erected, or other improvements made, by the lessee on the leased property, the portion of the term of the lease (excluding all periods for which the lease may subsequently be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining upon the completion of such building or other improvements is less than 60 percent of the estimated useful life of such building or other improvements; or

(ii) In the case of any cost of acquiring the lease, less than 75 percent of such cost is attributable to the portion of the term of the lease (excluding all periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee) remaining on the date of its acquisition.

(2) The rules provided in subparagraph (1) of this paragraph shall not apply if the lessee establishes that, as of the close of the taxable year, it is more probable that the lease will not be renewed, extended, or continued than that the lease will be renewed, extended, or continued. In such case, the cost of improvements made on leased property or the cost of acquiring a lease shall be amortized over the remaining term of the lease without regard to any options exercisable by the lessee to renew, extend, or continue the lease. The probability test referred to in the first sentence of this subparagraph shall be applicable to each option period to which the lease may be renewed, extended, or continued. The establishment by a lessee as of the close of the taxable year that it is more probable that the lease will not be renewed, extended, or continued will ordinarily be effective as of the close of such taxable year and any subsequent taxable year, and the deduction for amortization will be based on the term of the lease without regard to any periods for which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee. However, in appropriate cases, if the facts as of the close of any subsequent taxable year indicate that it is more probable that the lease will be renewed, extended, or continued, the deduction for amortization (or depreciation) shall, beginning with the first day of such subsequent taxable year, be determined by including in the remaining term of the lease all periods for which it is more probable that the lease will be renewed, extended, or continued.

(3) If at any time the remaining term of the lease determined in accordance with section 178 and this section is equal to or of longer duration than the

then estimated useful life of the improvements made on the leased property by the lessee, the cost of such improvements shall be depreciated over the estimated useful life of such improvements under the provisions of section 167 and the regulations thereunder.

(4) For purposes of section 178(a)(1) and this section, the date on which the building erected or other improvements made are completed is the date on which the building or improvements are usable, whether or not used.

(5)(i) For purposes of section 178(a)(2) and this section, the portion of the cost of acquiring a lease which is attributable to the term of the lease remaining on the date of its acquisition without regard to options exercisable by the lessee to renew, extend, or continue the lease shall be determined on the basis of the facts and circumstances of each case. In some cases, it may be appropriate to determine such portion of the cost of acquiring a lease by applying the principles used to measure the present value of an annuity. Where that method is used, such portion shall be determined by multiplying the cost of the lease by a fraction, the numerator comprised of a factor representing the present value of an annually recurring savings of $1 per year for the period of the remaining term of the lease (without regard to options to renew, extend, or continue the lease) at an appropriate rate of interest (determined on the basis of all the facts and circumstances in each case), and the denominator comprised of a factor representing the present value of $1 per year for the period of the remaining term of the lease including the options to renew, extend, or continue the lease at an appropriate rate of interest.

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

Example. Lessee A acquires a lease with respect to unimproved property at a cost of $100,000 at which time there are 21 years remaining in the original term of the lease with two renewal options of 21 years each. The lease provides for a uniform annual rental for the remaining term of the lease and the renewal periods. It has been determined that this is an appropriate case for the application of the principles used to measure the present value of an annuity. Assume that in this case the appropriate rate of interest is 5 percent. By applying the tables (Inwood) used to measure the present value of an annuity of $1 per year, the factor representing the present value of $1 per annum for 21 years at 5% is ascertained to be 12.821, and the factor representing the present value of $1 per annum for 63 years at 5% is 19.075. The portion of the cost of the lease ($100,000) attributable to the remaining term of the original lease (21 years) is 67.21% or $67,210 determined as follows:

12.821/19.075 or 67.21%.

(6) The provisions of this paragraph may be illustrated by the following examples:

Example 1. Lessee A constructs a building on land leased from lessor B. The construction is commenced on August 1, 1958, and is completed and placed in service on December 31, 1958, at which time A has 15 years remaining on his lease with an option to renew for an additional 20 years. Lessee A computes his taxable income on a calendar year basis. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. The building has an estimated useful life of 30 years. A is not related to B. Since the portion of the term of the lease (without regard to any renewals) remaining upon completion of the building (15 years) is less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years), the term of the lease shall be treated as including the remaining portion of the original lease period and the renewal period, or 35 years. Since the estimated useful life of the building (30 years) is less than 35 years, the cost of the building shall, in accord with paragraph (b)(3) of this section, be depreciated under the provisions of section 167, over its estimated useful life. If, however, lessee A establishes, as of the close of the taxable year 1958, it is more probable that the lease will not be renewed than that it will be renewed, then in such case the remaining term of the lease shall be treated as including only the 15-year period remaining in the original lease. Since this is less than the estimated useful life of the building, the remaining cost of the building would be amortized over such 15-year period under the provisions of section 162 and the regulations thereunder.

Example 2. Assume the same facts as in *Example 1*, except that A has 21 years remaining on his lease with an option to renew for an additional 10 years. Section 178(a) and paragraph (b)(1) of this section do not apply since the term of the lease remaining on the date of completion of the building (21 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years).

Example 3. Assume the same facts as in *Example 1,* except that A has no renewal option until July 1, 1961, when lessor B grants A an option to renew the lease for a 10-year period. Because there is no option to renew the lease, the term of the lease is, for the taxable years 1959 and 1960 and for the first six months of the taxable year 1961, determined without regard to section 178(a). However, as of July 1, 1961, the date the renewal option is granted, section 178(a) and paragraph (b)(1) of this section become applicable since the portion of the term of the lease remaining upon completion of the building (15 years) was less than 60 percent of the estimated useful life of the building (60 percent of 30 years, or 18 years). As of July 1, 1961, the term of the lease shall be treated as including the remaining portion of the original lease period (12½ years) and the 10-year renewal period, or 22½ years, unless lessee A can establish that, as of the close of 1961, it is more probable that the lease will not be renewed than that it will be.

Example 4. On January 1, 1959, lessee A pays $10,000 to acquire a lease for 20 years with two options exercisable by him to renew for periods of 5 years each. Of the total $10,000 cost to acquire the lease, $7,000 was paid for the original 20-year lease period and the balance of $3,000 was paid for the renewal options. Since the $7,000 cost of acquiring the initial lease is less than 75 percent of the $10,000 cost of the lease ($7,500), the term of the lease shall be treated as including the original lease period and the 2 renewal periods, or 30 years. However, if lessee A establishes that, as of the close of the taxable year 1959, it is more probable that the lease will not be renewed than that it will be renewed, the term of the lease shall be treated as including only the original lease period, or 20 years.

Example 5. Assume the same facts as in *Example 4,* except that the portion of the total cost ($10,000) paid for the 20-year original lease period is $8,000. Since the $8,000 cost of acquiring the original lease is not less than 75 percent of the $10,000 cost of the lease ($7,500), section 178(a) and paragraph (b)(1) of this section do not apply.

(c) *Application of section 178(a) where lessee gives notice to lessor of intention to exercise option.* (1) If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lessee shall, for purposes of applying the provisions of section 178(a) and paragraph (b)(1) of this section, take into account such renewal or extension in determining the portion of the term of the lease remaining upon the completion of the improvements or on the date of the acquisition of the lease.

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

Example 1. Lessee A constructs a building on land leased from lessor B. The construction was commenced on September 1, 1958, and was completed and placed in service on December 31, 1958. Lessee A was not, on July 28, 1958, under a binding legal obligation to erect the building. A and B are not related. At the time the building was completed (December 31, 1958), lessee A had 3 years remaining on his lease with 2 options to renew for periods of 20 years each. The estimated useful life of the building is 50 years. Prior to completion of the building, lessee A gives notice to lessor B of his intention to exercise the first 20-year option. Therefore, the portion of the term of the lease remaining on January 1, 1959, shall be the 3 years remaining in the original lease period plus the 20-year renewal period, or 23 years. Since the term of the lease remaining upon completion of the building (23 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years), the provisions of section 178(a) and paragraph (b)(1) of this section are applicable. Accordingly, the term of the lease shall be treated as including the aggregate of the remaining term of the original lease (23 years) and the second 20-year renewal period or 43 years, unless lessee A establishes that it is more probable that the lease will not be renewed, extended, or continued under the second 20-year option than that it will be so renewed, extended, or continued under such option. If this is established by lessee A, then the term of the lease shall be treated as including only the remaining portion of the original lease period and the first 20-year renewal period, or 23 years.

Example 2. Assume the same facts as in *Example 1,* except that the estimated useful life of the building is 30 years. Since the term of the lease remaining upon completion of the building (23 years) is not less than 60 percent of the estimated life of the building (60 percent of 30 years, or 18 years), the provisions of section 178(a) and paragraph (b)(1) of this section do not apply.

Example 3. If in *Examples 1* and (*2,* the lessee failed to give notice of his intention to exercise the renewal option, the renewal period would not be taken into account in computing the percentage requirements under section 178(a) and paragraph (b)(1) of this section. Thus, unless lessee A establishes the required probability, the provisions of section 178(a) and paragraph (b)(1) of this section would apply in both examples since the term of the lease remaining upon completion of the building (3 years) is less than 60 percent of the estimated useful life of the building in either example (60 percent of 50 years, or 30 years; 60 percent of 30 years, or 18 years).

(d) *Application of section 178 where lessee is related to lessor.* (1)(i) If the lessee and lessor are related persons within the meaning of section 178(b)(2) and §1.178–2 at any time during the taxable year, the lease shall be treated as including a period of not less duration than the remaining estimated useful life of improvements made by the lessee on leased property for purposes of determining the amount of deduction allowable to the lessee for such taxable year for depreciation or amortization in respect of any building erected or other improvements made on leased property. If the lessee and lessor cease to be related persons during any taxable year, then for the immediately following and subsequent taxable years during which they continue to be unrelated, the amount allowable to the lessee as a deduction shall be determined without reference to section 178(b) and in accordance with section 178(a) or section 178(c), whichever is applicable.

(ii) Although the related lessee and lessor rule of section 178(b) and §1.178–2 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between a lessee and lessor will be a significant factor in applying section 178 (a) and (c) in cases in which the lease may be renewed, extended, or continued pursuant to an option or options exercisable by the lessee.

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

Example 1. Lessee A constructs a building on land leased from lessor B. The construction was commenced on August 1, 1958, and was completed and put in service on December 31, 1958. Lessee A was not on July 28, 1958, under a binding legal obligation to erect the building. On the completion date of the building, lessee A had 20 years remaining in his original lease period with an option to renew for an additional 20 years. The building has an estimated useful life of 50 years. During the taxable years 1959 and 1960, A and B are related persons within the meaning of section 178(b)(2) and §1.178–2, but they are not related persons at any time during the taxable year 1961 or during any subsequent taxable year. Since A and B are related persons during the taxable years 1959 and 1960, the term of the lease shall, for each of those years, be treated as 50 years. Section 178(a) and paragraph (b)(1) of this section become applicable in the taxable year 1961 since A and B are not related persons at any time during that year and because the portion of the original lease period remaining at the time the building was completed (20 years) is less than 60 percent of the estimated useful life of the building (60 percent of 50 years, or 30 years). Thus, the term of the lease shall, beginning on January 1, 1961, be treated as including the remaining portion of the original lease period (18 years) and the renewal period (20 years), or 38 years, unless lessee A can establish that, as of the close of the taxable year 1961 or any subsequent taxable year, it is more probable that the lease will not be renewed than that it will be renewed.

Example 2. Assume the same facts as in *Example 1*, except that the estimated useful life of the building is 30 years. During the taxable years 1959 and 1960, the term of the lease shall be treated as 30 years. For the taxable year 1961, however, neither section 178(a) nor section 178(b) apply since the percentage requirement of section 178(a) and paragraph (b) of this section are not satisfied and A and B are not related persons within the meaning of section 178(b)(2) and §1.178–2.

[T.D. 6520, 25 FR 13689, Dec. 24, 1960]

§ 1.179–0 Table of contents for section 179 expensing rules.

This section lists captioned paragraphs contained in §§1.179–1 through 1.179–6.

§ 1.179–1 Election to Expense Certain Depreciable Assets

[T.D. 8455, 57 FR 61316, Dec. 24, 1992, as amended by T.D. 9146, 69 FR 46983, Aug. 4, 2004; T.D. 9209, 70 FR 40191, July 13, 2005]

§ 1.179–1 Election to expense certain depreciable assets.

(a) *In general.* Section 179(a) allows a taxpayer to elect to expense the cost (as defined in § 1.179–4(d)), or a portion of the cost, of section 179 property (as defined in § 1.179–4(a)) for the taxable year in which the property is placed in service (as defined in § 1.179–4(e)). The election is not available for trusts, estates, and certain noncorporate lessors. See paragraph (i)(2) of this section for rules concerning noncorporate lessors. However, section 179(b) provides certain limitations on the amount that a taxpayer may elect to expense in any one taxable year. See §§ 1.179–2 and 1.179–3 for rules relating to the dollar and taxable income limitations and the carryover of disallowed deduction rules. For rules describing the time and manner of making an election under section 179, see § 1.179–5. For the effective date, see § 1.179–6.

(b) *Cost subject to expense.* The expense deduction under section 179 is allowed for the entire cost or a portion of the cost of one or more items of section 179 property. This expense deduction is subject to the limitations of section 179(b) and § 1.179–2. The taxpayer may select the properties that are subject to the election as well as the portion of each property's cost to expense.

(c) *Proration not required*—(1) *In general.* The expense deduction under section 179 is determined without any proration based on—

(i) The period of time the section 179 property has been in service during the taxable year; or

(ii) The length of the taxable year in which the property is placed in service.

(2) *Example.* The following example illustrates the provisions of paragraph (c)(1) of this section.

Example. On December 1, 1991, X, a calendar-year corporation, purchases and places in service section 179 property costing $20,000. For the taxable year ending December 31, 1991, X may elect to claim a section 179 expense deduction on the property (subject to the limitations imposed under section 179(b)) without proration of its cost for the number of days in 1991 during which the property was in service.

(d) *Partial business use*—(1) *In general.* If a taxpayer uses section 179 property for trade or business as well as other purposes, the portion of the cost of the property attributable to the trade or business use is eligible for expensing under section 179 provided that more than 50 percent of the property's use in the taxable year is for trade or business purposes. The limitations of section179(b) and § 1.179–2 are applied to the portion of the cost attributable to the trade or business use.

(2) *Example.* The following example illustrates the provisions of paragraph (d)(1) of this section.

Example. A purchases section 179 property costing $10,000 in 1991 for which 80 percent of its use will be in A's trade or business. The cost of the property adjusted to reflect the business use of the property is $8,000 (80 percent × $10,000). Thus, A may elect to expense up to $8,000 of the cost of the property (subject to the limitations imposed under section 179(b) and § 1.179–2).

(3) *Additional rules that may apply.* If a section 179 election is made for ''listed property'' within the meaning of section 280F(d)(4) and there is personal use of the property, section 280F(d)(1), which provides rules that coordinate section 179 with the section 280F limitation on the amount of depreciation, may apply. If section 179 property is no longer predominantly used in the taxpayer's trade or business, paragraphs (e) (1) through (4) of this section, relating to recapture of the section 179 deduction, may apply.

(e) *Change in use; recapture*—(1) *In general.* If a taxpayer's section 179 property is not used predominantly in a trade or business of the taxpayer at any time before the end of the property's recovery period, the taxpayer must recapture in the taxable year in which the section 179 property is not used predominantly in a trade or business any benefit derived from expensing such property. The benefit derived from expensing the property is equal to the excess of the amount expensed under this section over the total amount that would have been allowable for prior taxable years and the taxable year of recapture as a deduction under section 168 (had section 179 not been elected) for the portion of the cost of the property to which the expensing relates (regardless of whether such excess reduced the taxpayer's tax liability). For purposes of the preceding sentence (i) the ''amount expensed under this section'' shall not include any amount that was not allowed as a deduction to a taxpayer because the taxpayer's aggregate amount of allowable section 179 expenses exceeded the section 179(b) dollar limitation, and (ii) in the case of an individual who does not elect to itemize deductions under section 63(g) in the taxable year of recapture, the amount allowable as a deduction under section 168 in the taxable year of recapture shall be determined by treating property used in the production of income other than rents or royalties as being property used for personal purposes. The amount to be recaptured shall be treated as ordinary income for the taxable year in which the property is no longer used predominantly in a trade or business of the taxpayer. For taxable years following the year of recapture, the taxpayer's deductions under section 1688(a) shall be determined as if no section 179 election with respect to the property had been made. However, see section 280F(d)(1) relating to the coordination of section 179 with the limitation on the amount of depreciation for luxury automobiles and where certain property is used for personal purposes. If the recapture rules of both section 280F(b)(2) and this paragraph (e)(1) apply to an item of section 179 property, the amount of recapture for such property shall be determined only under the rules of section 280F(b)(2).

(2) *Predominant use.* Property will be treated as not used predominantly in a trade or business of the taxpayer if 50 percent or more of the use of such property during any taxable year within the recapture period is for a use other than in a trade or business of the taxpayer. If during any taxable year of the recapture period the taxpayer disposes of the property (other than in a disposition to which section 1245(a) applies) or ceases to use the property in a trade or business in a manner that had the taxpayer claimed a credit under section 38 for such property such disposition or cessation in use would cause recapture under section 47, the property will be treated as not used in a trade or business of the taxpayer. However, for purposes of applying the recapture rules of section 47 pursuant to the preceding sentence, converting the use of the property from use in trade or business to use in the production of income will be treated as a conversion to personal use.

(3) *Basis; application with section 1245.* The basis of property with respect to which there is recapture under paragraph (e)(1) of this section shall be increased immediately before the event resulting in such recapture by the amount recaptured. If section 1245(a) applies to a disposition of property, there is no recapture under paragraph (e)(1) of this section.

(4) *Carryover of disallowed deduction.* See §1.179–3 for rules on applying the recapture provisions of this paragraph (e) when a taxpayer has a carryover of disallowed deduction.

(5) *Example.* The following example illustrates the provisions of paragraphs (e)(1) through (e)(4) of this section.

Example. A, a calendar-year taxpayer, purchases and places in service on January 1, 1991, section 179 property costing $15,000. The property is 5-year property for section 168 purposes and is the only item of depreciable property placed in service by A during 1991. A properly elects to expense $10,000 of the cost and elects under section 168(b)(5) to depreciate the remaining cost under the straight-line method. On January 1, 1992, A converts the property from use in A's business to use for the production of income, and A uses the property in the latter capacity for the entire year. A elects to itemize deductions for 1992. Because the property was not predominantly used in A's trade or business in 1992, A must recapture any benefit derived from expensing the property under section 179. Had A not elected to expense the $10,000 in 1991, A would have been entitled to deduct, under section 168, 10 percent of the $10,000 in 1991, and 20 percent of the $10,000 in 1992. Therefore, A must include $7,000 in ordinary income for the 1992 taxable year, the excess of $10,000 (the section 179 expense amount) over $3,000 (30 percent of $10,000).

(f) *Basis*—(1) *In general.* A taxpayer who elects to expense under section 179 must reduce the depreciable basis of the section 179 property by the amount of the section 179 expense deduction.

(2) *Special rules for partnerships and S corporations.* Generally, the basis of a partnership or S corporation's section 179 property must be reduced to reflect the amount of section 179 expense elected by the partnership or S corporation. This reduction must be made in the basis of partnership or S corporation property even if the limitations of section 179(b) and §1.179–2 prevent a partner in a partnership or a shareholder in an S corporation from

deducting all or a portion of the amount of the section 179 expense allocated by the partnership or S corporation. See §1.179–3 for rules on applying the basis provisions of this paragraph (f) when a person has a carryover of disallowed deduction.

(3) *Special rules with respect to trusts and estates which are partners or S corporation shareholders.* Since the section 179 election is not available for trusts or estates, a partner or S corporation shareholder that is a trust or estate may not deduct its allocable share of the section 179 expense elected by the partnership or S corporation. The partnership or S corporation's basis in section 179 property shall not be reduced to reflect any portion of the section 179 expense that is allocable to the trust or estate. Accordingly, the partnership or S corporation may claim a depreciation deduction under section 168 or a section 38 credit (if available) with respect to any depreciable basis resulting from the trust or estate's inability to claim its allocable portion of the section 179 expense.

(g) *Disallowance of the section 38 credit.* If a taxpayer elects to expense under section 179, no section 38 credit is allowable for the portion of the cost expensed. In addition, no section 38 credit shall be allowed under section 48(d) to a lessee of property for the portion of the cost of the property that the lessor expensed under section 179.

(h) *Partnerships and S corporations*—(1) *In general.* In the case of property purchased and placed in service by a partnership or an S corporation, the determination of whether the property is section 179 property is made at the partnership or S corporation level. The election to expense the cost of section 179 property is made by the partnership or the S corporation. See sections 703(b), 1363(c), 6221, 6231(a)(3), 6241, and 6245.

(2) *Example.* The following example illustrates the provisions of paragraph (h)(1) of this section.

Example. A owns certain residential rental property as an investment. A and others form ABC partnership whose function is to rent and manage such property. A and ABC partnership file their income tax returns on a calendar-year basis. In 1991, ABC partnership purchases and places in service office furniture costing $20,000 to be used in the active conduct of ABC's business. Although the office furniture is used with respect to an investment activity of A, the furniture is being used in the active conduct of ABC's trade or business. Therefore, because the determination of whether property is section 179 property is made at the partnership level, the office furniture is section 179 property and ABC may elect to expense a portion of its cost under section 179.

(i) *Leasing of section 179 property*—(1) *In general.* A lessor of section 179 property who is treated as the owner of the property for Federal tax purposes will be entitled to the section 179 expense deduction if the requirements of section 179 and the regulations thereunder are met. These requirements will not be met if the lessor merely holds the property for the production of income. For certain leases entered into prior to January 1, 1984, the safe harbor provisions of section 168(f)(8) apply in determining whether an agreement is treated as a lease for Federal tax purposes.

(2) *Noncorporate lessor.* In determining the class of taxpayers (other than an estate or trust) for which section 179 is applicable, section 179(d)(5) provides that if a taxpayer is a noncorporate lessor (*i.e.*, a person who is not a corporation and is a lessor), the taxpayer shall not be entitled to claim a section 179 expense for section 179 property purchased and leased by the taxpayer unless the taxpayer has satisfied all of the requirements of section 179(d)(5) (A) or (B).

(j) *Application of sections 263 and 263A.* Under section 263(a)(1)(G), expenditures for which a deduction is allowed under section 179 and this section are excluded from capitalization under section 263(a). Under this paragraph (j), amounts allowed as a deduction under section 179 and this section are excluded from the application of the uniform capitalization rules of section 263A.

(k) *Cross references.* See section 453(i) and the regulations thereunder with respect to installment sales of section 179 property. See section 1033(g)(3) and the regulations thereunder relating to condemnation of outdoor advertising displays. See section 1245(a) and the regulations thereunder with respect to recapture rules for section 179 property.

[T.D. 8121, 52 FR 410, Jan. 6, 1987, as amended by T.D. 8455, 57 FR 61316, Dec. 24, 1992]

§ 1.179–2 Limitations on amount subject to section 179 election.

(a) *In general.* Sections 179(b) (1) and (2) limit the aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any one taxable year (dollar limitation). See paragraph (b) of this section. Section 179(b)(3)(A) limits the aggregate cost of section 179 property that a taxpayer may deduct in any taxable year (taxable income limitation). See paragraph (c) of this section. Any cost that is elected to be expensed but that is not currently deductible because of the taxable income limitation may be carried forward to the next taxable year (carryover of disallowed deduction). See §1.179–3 for rules relating to carryovers of disallowed deductions. See also sections 280F(a), (b), and (d)(1) relating to the coordination of section 179 with the limitations on the amount of depreciation for luxury automobiles and other listed property. The dollar and taxable income limitations apply to each taxpayer and not to each trade or business in which the taxpayer has an interest.

(b) *Dollar limitation*—(1) *In general.* The aggregate cost of section 179 property that a taxpayer may elect to expense under section 179 for any taxable year beginning in 2003 and thereafter is $25,000 ($100,000 in the case of taxable years beginning after 2002 and before 2008 under section 179(b)(1), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2008), reduced (but not below zero) by the amount of any excess section 179 property (described in paragraph (b)(2) of this section) placed in service during the taxable year.

(2) *Excess section 179 property.* The amount of any excess section 179 property for a taxable year equals the excess (if any) of—

(i) The cost of section 179 property placed in service by the taxpayer in the taxable year; over

(ii) $200,000 ($400,000 in the case of taxable years beginning after 2002 and before 2008 under section 179(b)(2), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2008).

(3) *Application to partnerships*—(i) *In general.* The dollar limitation of this paragraph (b) applies to the partnership as well as to each partner. In applying the dollar limitation to a taxpayer that is a partner in one or more partnerships, the partner's share of section 179 expenses allocated to the partner from each partnership is aggregated with any nonpartnership section 179 expenses of the taxpayer for the taxable year. However, in determining the excess section 179 property placed in service by a partner in a taxable year, the cost of section 179 property placed in service by the partnership is not attributed to any partner.

(ii) *Example.* The following example illustrates the provisions of paragraph (b)(3)(i) of this section.

Example. During 1991, CD, a calendar-year partnership, purchases and places in service section 179 property costing $150,000 and elects under section 179(c) and §1.179–5 to expense $10,000 of the cost of that property. CD properly allocates to C, a calendar-year taxpayer and a partner in CD, $5,000 of section 179 expenses (C's distributive share of CD's section 179 expenses for 1991). In applying the dollar limitation to C for 1991, C must include the $5,000 of section 179 expenses allocated from CD. However, in determining the amount of any excess section 179 property C placed in service during 1991, C does not include any of the cost of section 179 property placed in service by CD, including the $5,000 of cost represented by the $5,000 of section 179 expenses allocated to C by the partnership.

(iii) *Partner's share of section 179 expenses.* Section 704 and the regulations thereunder govern the determination of a partner's share of a partnership's section 179 expenses for any taxable year. However, no allocation among partners of the section 179 expenses may be modified after the due date of the partnership return (without regard to extensions of time) for the taxable year for which the election under section 179 is made.

(iv) *Taxable year.* If the taxable years of a partner and the partnership do not coincide, then for purposes of section 179, the amount of the partnership's section 179 expenses attributable to a partner for a taxable year is determined under section 706 and the regulations thereunder (generally the partner's distributive share of partnership section 179 expenses for the partnership year that ends with or within the partner's taxable year).

(v) *Example.* The following example illustrates the provisions of paragraph (b)(3)(iv) of this section.

Example. AB partnership has a taxable year ending January 31. A, a partner of AB, has a taxable year ending December 31. AB purchases and places in service section 179 property on March 10, 1991, and elects to expense a portion of the cost of that property under section 179. Under section 706 and §1.706–1(a)(1), A will be unable to claim A's distributive share of any of AB's section 179 expenses attributable to the property placed in service on March 10, 1991, until A's taxable year ending December 31, 1992.

(4) *S Corporations.* Rules similar to those contained in paragraph (b)(3) of this section apply in the case of S corporations (as defined in section 1361(a)) and their shareholders. Each shareholder's share of the section 179 expenses of an S corporation is determined under section 1366.

(5) *Joint returns*—(i) *In General.* A husband and wife who file a joint income tax return under section 6013(a) are treated as one taxpayer in determining the amount of the dollar limitation under paragraph (b)(1) of this section, regardless of which spouse purchased the property or placed it in service.

(ii) *Joint returns filed after separate returns.* In the case of a husband and wife who elect under section 6013(b) to file a joint income tax return for a taxable year after the time prescribed by law for filing the return for such taxable year has expired, the dollar limitation under paragraph (b)(1) of this section is the lesser of—

(A) The dollar limitation (as determined under paragraph (b)(5)(i) of this section); or

(B) The aggregate cost of section 179 property elected to be expensed by the husband and wife on their separate returns.

(iii) *Example.* The following example illustrates the provisions of paragraph (b)(5)(ii) of this section.

Example. During 1991, Mr. and Mrs. B, both calendar-year taxpayers, purchase and place in service section 179 property costing $100,000. On their separate returns for 1991, Mr. B elects to expense $3,000 of section 179 property as an expense and Mrs. B elects to expense $4,000. After the due date of the return they elect under section 6013(b) to file a joint income tax return for 1991. The dollar limitation for their joint income tax return is $7,000, the lesser of the dollar limitation ($10,000) or the aggregate cost elected to be expensed under section 179 on their separate returns ($3,000 elected by Mr. B plus $4,000 elected by Mrs. B, or $7,000).

(6) *Married individuals filing separately*—(i) *In general.* In the case of an individual who is married but files a separate income tax return for a taxable year, the dollar limitation of this paragraph (b) for such taxable year is the amount that would be determined under paragraph (b)(5)(i) of this section if the individual filed a joint income tax return under section 6013(a) multiplied by either the percentage elected by the individual under this paragraph (b)(6) or 50 percent. The election in the preceding sentence is made in accordance with the requirements of section 179(c) and §1.179–5. However, the amount determined under paragraph (b)(5)(i) of this section must be multiplied by 50 percent if either the individual or the individual's spouse does not elect a percentage under this paragraph (b)(6) or the sum of the percentages elected by the individual and the individual's spouse does not equal 100 percent. For purposes of this paragraph (b)(6), marital status is determined under section 7703 and the regulations thereunder.

(ii) *Example.* The following example illustrates the provisions of paragraph (b)(6)(i) of this section.

Example. Mr. and Mrs. D, both calendar-year taxpayers, file separate income tax returns for 1991. During 1991, Mr. D places $195,000 of section 179 property in service and Mrs. D places $9,000 of section 179 property in service. Neither of them elects a percentage under paragraph (b)(6)(i) of this section. The 1991 dollar limitation for both Mr. D and Mrs. D is determined by multiplying by 50 percent the dollar limitation that would apply had they filed a joint income tax return. Had Mr. and Mrs. D filed a joint return for 1991, the dollar limitation would have been $6,000, $10,000 reduced by the excess section 179 property they placed in service during 1991 ($195,000 placed in service by Mr. D plus $9,000 placed in service by Mrs. D less $200,000, or $4,000). Thus, the 1991 dollar limitation for Mr. and Mrs. D is $3,000 each ($6,000 multiplied by 50 percent).

(7) *Component members of a controlled group*—(i) *In general.* Component members of a controlled group (as defined in §1.179–4(f)) on December 31 are treated as one taxpayer in applying the dollar limitation of sections 179(b) (1) and (2) and this paragraph (b). The expense deduction may be taken by any one component member or allocated (for the taxable year of each member that includes that December 31) among the several members in any manner. Any allocation of the expense deduction must be pursuant to an allocation by the common parent corporation if a consolidated return is filed for all component members of the group, or in accordance with an agreement entered into by the members of the group if separate returns are filed. If a consolidated return is filed by some component members of the group and separate returns are filed by other component members, the common parent of the group filing the consolidated return must enter into an agreement with those members that do not join in filing the consolidated return allocating the amount between the group filing the consolidated return and the other component members of the controlled group that do not join in filing the consolidated return. The amount of the expense allocated to any component member, however, may not exceed the cost of section 179 property actually purchased and placed in service by the member in the taxable year. If the component members have different taxable years, the term *taxable year* in sections 179(b) (1) and (2) means the taxable year of the member whose taxable year begins on the earliest date.

(ii) *Statement to be filed.* If a consolidated return is filed, the common parent corporation must file a separate statement attached to the income tax return on which the election is made to claim an expense deduction under section 179. See §1.179–5. If separate returns are filed by some or all component members of the group, each component member not included in a consolidated return must file a separate statement attached to the income tax return on which an election is made to claim a deduction under section 179. The statement must include the name, address, employer identification number, and the taxable year of each component member of the controlled group, a copy of the allocation agreement signed by persons duly authorized to act on behalf of the component members, and a description of the manner in which the deduction under section 179 has been divided among the component members.

(iii) *Revocation.* If a consolidated return is filed for all component members of the group, an allocation among such members of the expense deduction under section 179 may not be revoked after the due date of the return (including extensions of time) of the common parent corporation for the taxable year for which an election to take an expense deduction is made. If some or all of the component members of the controlled group file separate returns for taxable years including a particular December 31 for which an election to take the expense deduction is made, the allocation as to all members of the group may not be revoked after the due date of the return (including extensions of time) of the component member of the controlled group whose taxable year that includes such December 31 ends on the latest date.

(c) *Taxable income limitation*—(1) *In general.* The aggregate cost of section 179 property elected to be expensed under section 179 that may be deducted for any taxable year may not exceed the aggregate amount of taxable income of the taxpayer for such taxable year that is derived from the active conduct by the taxpayer of any trade or business during the taxable year. For purposes of section 179(b)(3) and this paragraph (c), the aggregate amount of taxable income derived from the active conduct by an individual, a partnership, or an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the individual, partnership, or S corporation during the taxable year. Items of income that are derived from the active conduct of a trade or business include section 1231 gains (or losses) from the trade or business and interest from working capital of the trade or business. Taxable income derived from the active conduct of a trade or business is computed without regard to the deduction allowable under section 179, any section 164(f) deduction, any net operating loss carryback or carryforward, and deductions suspended under any section of the Code. See paragraph (c)(6) of this section for rules on determining whether a taxpayer is engaged in the active conduct of a trade or business for this purpose.

(2) *Application to partnerships and partners*—(i) *In general*. The taxable income limitation of this paragraph (c) applies to the partnership as well as to each partner. Thus, the partnership may not allocate to its partners as a section 179 expense deduction for any taxable year more than the partnership's taxable income limitation for that taxable year, and a partner may not deduct as a section 179 expense deduction for any taxable year more than the partner's taxable income limitation for that taxable year.

(ii) *Taxable year*. If the taxable year of a partner and the partnership do not coincide, then for purposes of section 179, the amount of the partnership's taxable income attributable to a partner for a taxable year is determined under section 706 and the regulations thereunder (generally the partner's distributive share of partnership taxable income for the partnership year that ends with or within the partner's taxable year).

(iii) *Example*. The following example illustrates the provisions of paragraph (c)(2)(ii) of this section.

Example. AB partnership has a taxable year ending January 31. A, a partner of AB, has a taxable year ending December 31. For AB's taxable year ending January 31, 1992, AB has taxable income from the active conduct of its trade or business of $100,000, $90,000 of which was earned during 1991. Under section 706 and §1.706–1(a)(1), A includes A's entire share of partnership taxable income in computing A's taxable income limitation for A's taxable year ending December 31, 1992.

(iv) *Taxable income of a partnership*. The taxable income (or loss) derived from the active conduct by a partnership of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the partnership during the taxable year. The net income (or loss) from a trade or business actively conducted by the partnership is determined by taking into account the aggregate amount of the partnership's items described in section 702(a) (other than credits, tax-exempt income, and guaranteed payments under section 707(c)) derived from that trade or business. For purposes of determining the aggregate amount of partnership items, deductions and losses are treated as negative income. Any limitation on the amount of a partnership item described in section 702(a) which may be taken into account for purposes of computing the taxable income of a partner shall be disregarded in computing the taxable income of the partnership.

(v) *Partner's share of partnership taxable income*. A taxpayer who is a partner in a partnership and is engaged in the active conduct of at least one of the partnership's trades or businesses includes as taxable income derived from the active conduct of a trade or business the amount of the taxpayer's allocable share of taxable income derived from the active conduct by the partnership of any trade or business (as determined under paragraph (c)(2)(iv) of this section).

(3) *S corporations and S corporation shareholders*—(i) *In general*. Rules similar to those contained in paragraphs (c)(2) (i) and (ii) of this section apply in the case of S corporations (as defined in section 1361(a)) and their shareholders. Each shareholder's share of the taxable income of an S corporation is determined under section 1366.

(ii) *Taxable income of an S corporation*. The taxable income (or loss) derived from the active conduct by an S corporation of any trade or business is computed by aggregating the net income (or loss) from all of the trades or businesses actively conducted by the S corporation during the taxable year. The net income (or loss) from a trade or business actively conducted by an S corporation is determined by taking into account the aggregate amount of the S corporation's items described in section 1366(a) (other than credits, tax-exempt income, and deductions for compensation paid to an S corporation's shareholder-employees) derived from that trade or business. For purposes of determining the aggregate amount of S corporation items, deductions and losses are treated as negative income. Any limitation on the amount of an S corporation item described in section 1366(a) which may be taken into account for purposes of computing the taxable income of a shareholder shall be disregarded in computing the taxable income of the S corporation.

(iii) *Shareholder's share of S corporation taxable income*. Rules similar to those contained in paragraph (c)(2)(v) and (c)(6)(ii) of this section apply to a taxpayer who is a shareholder in an S corporation and is engaged in the active conduct of the S corporation's trades or businesses.

(4) *Taxable income of a corporation other than an S corporation*. The aggregate amount of taxable income derived from the active conduct by a corporation other than an S corporation of any trade or business is the amount of the corporation's taxable income before deducting its net operating loss deduction and special deductions (as reported on the corporation's income tax return), adjusted to reflect those items of income or deduction included in that amount that were not derived by the corporation from a trade or business actively conducted by the corporation during the taxable year.

(5) *Ordering rule for certain circular problems*—(i) *In general*. A taxpayer who elects to expense the cost of section 179 property (the deduction of which is subject to the taxable income limitation) also may have to apply another Internal Revenue Code section that has a limitation based on the taxpayer's taxable income. Except as provided in paragraph (c)(1) of this section, this section provides rules for applying the taxable income limitation under section 179 in such a case. First, taxable income is computed for the other section of the Internal Revenue Code. In computing the taxable income of the taxpayer for the other section of the Internal Revenue Code, the taxpayer's section 179 deduction is computed by assuming that the taxpayer's taxable income is determined without regard to the deduction under the other Internal Revenue Code section. Next, after reducing taxable income by the amount of the section 179 deduction so computed, a hypothetical amount of deduction is determined for the other section of the Internal Revenue Code. The taxable income limitation of the taxpayer under section 179(b)(3) and this paragraph (c) then is computed by including that hypothetical amount in determining taxable income.

(ii) *Example*. The following example illustrates the ordering rule described in paragraph (c)(5)(i) of this section.

Example. X, a calendar-year corporation, elects to expense $10,000 of the cost of section 179 property purchased and placed in service during 1991. Assume X's dollar limitation is $10,000. X also gives a charitable contribution of $5,000 during the taxable year. X's taxable income for purposes of both sections 179 and 170(b)(2), but without regard to any deduction allowable under either section 179 or section 170, is $11,000. In determining X's taxable income limitation under section 179(b)(3) and this paragraph (c), X must first compute its section 170 deduction. However, section 170(b)(2) limits X's charitable contribution to 10 percent of its taxable income determined by taking into account its section 179 deduction. Paragraph (c)(5)(i) of this section provides that in determining X's section 179 deduction for 1991, X first computes a hypothetical section 170 deduction by assuming that its section 179 deduction is not affected by the section 170 deduction. Thus, in computing X's hypothetical section 170 deduction, X's taxable income limitation under section 179 is $11,000 and its section 179 deduction is $10,000. X's hypothetical section 170 deduction is $100 (10 percent of $1,000 ($11,000 less $10,000 section 179 deduction)). X's taxable income limitation for section 179 purposes is then computed by deducting the hypothetical charitable contribution of $100 for 1991. Thus, X's section 179 taxable income limitation is $10,900 ($11,000 less hypothetical $100 section 170 deduction), and its section 179 deduction for 1991 is $10,000. X's section 179 deduction so calculated applies for all purposes of the Code, including the computation of its actual section 170 deduction.

(6) *Active conduct by the taxpayer of a trade or business*—(i) *Trade or business*. For purposes of this section and § 1.179–4(a), the term *trade or business* has the same meaning as in section 162 and the regulations thereunder. Thus, property held merely for the production of income or used in an activity not engaged in for profit (as described in section 183) does not qualify as section 179 property and taxable income derived from property held for the production

of income or from an activity not engaged in for profit is not taken into account in determining the taxable income limitation.

(ii) *Active conduct.* For purposes of this section, the determination of whether a trade or business is actively conducted by the taxpayer is to be made from all the facts and circumstances and is to be applied in light of the purpose of the active conduct requirement of section 179(b)(3)(A). In the context of section 179, the purpose of the active conduct requirement is to prevent a passive investor in a trade or business from deducting section 179 expenses against taxable income derived from that trade or business. Consistent with this purpose, a taxpayer generally is considered to actively conduct a trade or business if the taxpayer meaningfully participates in the management or operations of the trade or business. Generally, a partner is considered to actively conduct a trade or business of the partnership if the partner meaningfully participates in the management or operations of the trade or business. A mere passive investor in a trade or business does not actively conduct the trade or business.

(iii) *Example.* The following example illustrates the provisions of paragraph (c)(6)(ii) of this section.

Example. A owns a salon as a sole proprietorship and employs B to operate it. A periodically meets with B to review developments relating to the business. A also approves the salon's annual budget that is prepared by B. B performs all the necessary operating functions, including hiring beauticians, acquiring the necessary beauty supplies, and writing the checks to pay all bills and the beauticians' salaries. In 1991, B purchased, as provided for in the salon's annual budget, equipment costing $9,500 for use in the active conduct of the salon. There were no other purchases of section 179 property during 1991. A's net income from the salon, before any section 179 deduction, totaled $8,000. A also is a partner in PRS, a calendar-year partnership, which owns a grocery store. C, a partner in PRS, runs the grocery store for the partnership, making all the management and operating decisions. PRS did not purchase any section 179 property during 1991. A's allocable share of partnership net income was $6,000. Based on the facts and circumstances, A meaningfully participates in the management of the salon. However, A does not meaningfully participate in the management or operations of the trade or business of PRS. Under section 179(b)(3)(A) and this paragraph (c), A's aggregate taxable income derived from the active conduct by A of any trade or business is $8,000, the net income from the salon.

(iv) *Employees.* For purposes of this section, employees are considered to be engaged in the active conduct of the trade or business of their employment. Thus, wages, salaries, tips, and other compensation (not reduced by unreimbursed employee business expenses) derived by a taxpayer as an employee are included in the aggregate amount of taxable income of the taxpayer under paragraph (c)(1) of this section.

(7) *Joint returns*—(i) *In general.* The taxable income limitation of this paragraph (c) is applied to a husband and wife who file a joint income tax return under section 6013(a) by aggregating the taxable income of each spouse (as determined under paragraph (c)(1) of this section).

(ii) *Joint returns filed after separate returns.* In the case of a husband and wife who elect under section 6013(b) to file a joint income tax return for a taxable year after the time prescribed by law for filing the return for such taxable year, the taxable income limitation of this paragraph (c) for the taxable year for which the joint return is filed is determined under paragraph (c)(7)(i) of this section.

(8) *Married individuals filing separately.* In the case of an individual who is married but files a separate tax return for a taxable year, the taxable income limitation for that individual is determined under paragraph (c)(1) of this section by treating the husband and wife as separate taxpayers.

(d) *Examples.* The following examples illustrate the provisions of paragraphs (b) and (c) of this section.

Example 1. (i) During 1991, PRS, a calendar-year partnership, purchases and places in service $50,000 of section 179 property. The taxable income of PRS derived from the active conduct of all its trades or businesses (as determined under paragraph (c)(1) of this section) is $8,000.

(ii) Under the dollar limitation of paragraph (b) of this section, PRS may elect to expense $10,000 of the cost of section 179 property purchased in 1991. Assume PRS elects under section 179(c) and §1.179–5 to expense $10,000 of the cost of section 179 property purchased in 1991.

(iii) Under the taxable income limitation of paragraph (c) of this section, PRS may allocate to its partners as a deduction only $8,000 of the cost of section 179 property in 1991. Under section 179(b)(3)(B) and §1.179–3(a), PRS may carry forward the remaining $2,000 it elected to expense, which would have been deductible under section 179(a) for 1991 absent the taxable income limitation.

Example 2. (i) The facts are the same as in *Example 1*, except that on December 31, 1991, PRS allocates to A, a calendar-year taxpayer and a partner in PRS, $7,000 of section 179 expenses and $2,000 of taxable income. A was engaged in the active conduct of a trade or business of PRS during 1991.

(ii) In addition to being a partner in PRS, A conducts a business as a sole proprietor. During 1991, A purchases and places in service $201,000 of section 179 property in connection with the sole proprietorship. A's 1991 taxable income derived from the active conduct of this business is $6,000.

(iii) Under the dollar limitation, A may elect to expense only $9,000 of the cost of section 179 property purchased in 1991, the $10,000 limit reduced by $1,000 (the amount by which the cost of section 179 property placed in service during 1991 ($201,000) exceeds $200,000). Under paragraph (b)(3)(i) of this section, the $7,000 of section 179 expenses allocated from PRS is subject to the $9,000 limit. Assume that A elects to expense $2,000 of the cost of section 179 property purchased by A's sole proprietorship in 1991. Thus, A has elected to expense under section 179 an amount equal to the dollar limitation for 1991 ($2,000 elected to be expensed by A's sole proprietorship plus $7,000, the amount of PRS's section 179 expenses allocated to A in 1991).

(iv) Under the taxable income limitation, A may only deduct $8,000 of the cost of section 179 property elected to be expensed in 1991, the aggregate taxable income derived from the active conduct of A's trades or businesses in 1991 ($2,000 from PRS and $6,000 from A's sole proprietorship). The entire $2,000 of taxable income allocated from PRS is included by A as taxable income derived from the active conduct by A of a trade or business because it was derived from the active conduct of a trade or business by PRS and A was engaged in the active conduct of a trade or business of PRS during 1991. Under section 179(b)(3)(B) and §1.179–3(a), A may carry forward the remaining $1,000 A elected to expense, which would have been deductible under section 179(a) for 1991 absent the taxable income limitation.

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§1.179–3 Carryover of disallowed deduction.

(a) *In general.* Under section 179(b)(3)(B), a taxpayer may carry forward for an unlimited number of years the amount of any cost of section 179 property elected to be expensed in a taxable year but disallowed as a deduction in that taxable year because of the taxable income limitation of section 179(b)(3)(A) and §1.179–2(c) (''carryover of disallowed deduction''). This carryover of disallowed deduction may be deducted under section 179(a) and §1.179–1(a) in a future taxable year as provided in paragraph (b) of this section.

(b) *Deduction of carryover of disallowed deduction*—(1) *In general.* The amount allowable as a deduction under section 179(a) and §1.179–1(a) for any taxable year is increased by the lesser of—

(i) The aggregate amount disallowed under section 179(b)(3)(A) and §1.179–2(c) for all prior taxable years (to the extent not previously allowed as a deduction by reason of this section); or

(ii) The amount of any unused section 179 expense allowance for the taxable year (as described in paragraph (c) of this section).

(2) *Cross references.* See paragraph (f) of this section for rules that apply when a taxpayer disposes of or otherwise transfers section 179 property for which a carryover of disallowed deduction is outstanding. See paragraph (g) of this section for special rules that apply to partnerships and S corporations and paragraph (h) of this section for special rules that apply to partners and S corporation shareholders.

(c) *Unused section 179 expense allowance.* The amount of any unused section 179 expense allowance for a taxable year equals the excess (if any) of—

(1) The maximum cost of section 179 property that the taxpayer may deduct under section 179 and §1.179–1 for the taxable year after applying the limitations of section 179(b) and §1.179–2; over

(2) The amount of section 179 property that the taxpayer actually elected to expense under section 179 and §1.179–1(a) for the taxable year.

(d) *Example.* The following example illustrates the provisions of paragraphs (b) and (c) of this section.

Example. A, a calendar-year taxpayer, has a $3,000 carryover of disallowed deduction for an item of section 179 property purchased and placed in service in 1991. In 1992, A purchases and places in service an item of section 179 property costing $25,000. A's 1992 taxable income from the active conduct of all A's trades or businesses is $100,000. A elects, under section 179(c) and §1.179–5, to expense $8,000 of the cost of the item of section 179 property purchased in 1992. Under paragraph (b) of this section, A may deduct $2,000 of A's carryover of disallowed deduction from 1991 (the lesser of A's total outstanding carryover of disallowed deductions ($3,000), or the amount of any unused section 179 expense allowance for 1992 ($10,000 limit less $8,000 elected to be expensed, or $2,000)). For 1993, A has a $1,000 carryover of disallowed deduction for the item of section 179 property purchased and placed in service in 1991.

(e) *Recordkeeping requirement and ordering rule.* The properties and the apportionment of cost that will be subject to a carryover of disallowed deduction are selected by the taxpayer in the year the properties are placed in service. This selection must be evidenced on the taxpayer's books and records and be applied consistently in subsequent years. If no selection is made, the total carryover of disallowed deduction is apportioned equally over the items of section 179 property elected to be expensed for the taxable year. For this purpose, the taxpayer treats any section 179 expense amount allocated from a partnership (or an S corporation) for a taxable year as one item of section 179 property. If the taxpayer is allowed to deduct a portion of the total carryover of disallowed deduction under paragraph (b) of this section, the taxpayer must deduct the cost of section 179 property carried forward from the earliest taxable year.

(f) *Dispositions and other transfers of section 179 property*—(1) *In general.* Upon a sale or other disposition of section 179 property, or a transfer of section 179 property in a transaction in which gain or loss is not recognized in whole or in part (including transfers at death), immediately before the transfer the adjusted basis of the section 179 property is increased by the amount of any outstanding carryover of disallowed deduction with respect to the property. This carryover of disallowed deduction is not available as a deduction to the transferor or the transferee of the section 179 property.

(2) *Recapture under section 179(d)(10).* Under §1.179–1(e), if a taxpayer's section 179 property is subject to recapture under section 179(d)(10), the taxpayer must recapture the benefit derived from expensing the property. Upon recapture, any outstanding carryover of disallowed deduction with respect to the property is no longer available for expensing. In determining the amount subject to recapture under section 179(d)(10) and §1.179–1(e), any outstanding carryover of disallowed deduction with respect to that property is not treated as an amount expensed under section 179.

(g) *Special rules for partnerships and S corporations*—(1) *In general.* Under section 179(d)(8) and §1.179–2(c), the taxable income limitation applies at the partnership level as well as at the partner level. Therefore, a partnership may have a carryover of disallowed deduction with respect to the cost of its section 179 property. Similar rules apply to S corporations. This paragraph (g) provides special rules that apply when a partnership or an S corporation has a carryover of disallowed deduction.

(2) *Basis adjustment.* Under §1.179–1(f)(2), the basis of a partnership's section 179 property must be reduced to reflect the amount of section 179 expense elected by the partnership. This reduction must be made for the taxable year for which the election is made even if the section 179 expense amount, or a portion thereof, must be carried forward by the partnership. Similar rules apply to S corporations.

(3) *Dispositions and other transfers of section 179 property by a partnership or an S corporation.* The provisions of paragraph (f) of this section apply in determining the treatment of any outstanding carryover of disallowed deduction with respect to section 179 property disposed of, or transferred in a nonrecognition transaction, by a partnership or an S corporation.

(4) *Example.* The following example illustrates the provisions of this paragraph (g).

Example. ABC, a calendar-year partnership, owns and operates a restaurant business. During 1992, ABC purchases and places in service two items of section 179 property—a cash register costing $4,000 and office furniture costing $6,000. ABC elects to expense under section 179(c) the full cost of the cash register and the office furniture. For 1992, ABC has $6,000 of taxable income derived from the active conduct of its restaurant business. Therefore, ABC may deduct only $6,000 of section 179 expenses and must carry forward the remaining $4,000 of section 179 expenses at the partnership level. ABC must reduce the adjusted basis of the section 179 property by the full amount elected to be expensed. However, ABC may not allocate to its partners any portion of the carryover of disallowed deduction until ABC is able to deduct it under paragraph (b) of this section.

(h) *Special rules for partners and S corporation shareholders*—(1) *In general.* Under section 179(d)(8) and §1.179–2(c), a partner may have a carryover of disallowed deduction with respect to the cost of section 179 property elected to be expensed by the partnership and allocated to the partner. A partner who is allocated section 179 expenses from a partnership must reduce the basis of his or her partnership interest by the full amount allocated regardless of whether the partner may deduct for the taxable year the allocated section 179 expenses or is required to carry forward all or a portion of the expenses. Similar rules apply to S corporation shareholders.

(2) *Dispositions and other transfers of a partner's interest in a partnership or a shareholder's interest in an S corporation.* A partner who disposes of a partnership interest, or transfers a partnership interest in a transaction in which gain or loss is not recognized in whole or in part (including transfers of a partnership interest at death), may have an outstanding carryover of disallowed deduction of section 179 expenses allocated from the partnership. In such a case, immediately before the transfer the partner's basis in the partnership interest is increased by the amount of the partner's outstanding carryover of disallowed deduction with respect to the partnership interest. This carryover of disallowed deduction is not available as a deduction to the transferor or transferee partner of the section 179 property. Similar rules apply to S corporation shareholders.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (h).

Example 1. (i) G is a general partner in GD, a calendar-year partnership, and is engaged in the active conduct of GD's business. During 1991, GD purchases and places section 179 property in service and elects to expense a portion of the cost of the property under section 179. GD allocates $2,500 of section 179 expenses and $15,000 of taxable income (determined without regard to the section 179 deduction) to G. The income was derived from the active conduct by GD of a trade or business.

(ii) In addition to being a partner in GD, G conducts a business as a sole proprietor. During 1991, G purchases and places in service office equipment costing $25,000 and a computer costing $10,000 in connection with the sole proprietorship. G elects under section 179(c) and §1.179–5 to expense $7,500 of the cost of the office equipment. G has a taxable loss (determined without regard to the section 179 deduction) derived from the active conduct of this business of $12,500.

(iii) G has no other taxable income (or loss) derived from the active conduct of a trade or business during 1991. G's taxable income limitation for 1991 is $2,500 ($15,000 taxable income allocated from GD less $12,500 taxable loss from the sole proprietorship). Therefore, G may deduct during 1991 only $2,500 of the $10,000 of section 179 expenses. G notes on the appropriate books and records that G expenses the $2,500 of section 179 expenses allocated from GD and carries forward the $7,500 of section 179 expenses with respect to the office equipment purchased by G's sole proprietorship.

(iv) On January 1, 1992, G sells the office equipment G's sole proprietorship purchased and placed in service in 1991. Under paragraph (f) of this section, immediately before the sale G increases the adjusted basis of the office equipment by $7,500, the amount of the outstanding carryover of disallowed deduction with respect to the office equipment.

Example 2. (i) Assume the same facts as in *Example 1,* except that G notes on the appropriate books and records that G expenses $2,500 of section 179 expenses relating to G's sole proprietorship and carries forward the remaining $5,000 of section 179 expenses relating to G's sole proprietorship and $2,500 of section 179 expenses allocated from GD.

(ii) On January 1, 1992, G sells G's partnership interest to A. Under paragraph (h)(2) of this section, immediately before the sale G increases the adjusted basis of G's partnership interest by $2,500, the amount of the outstanding carryover of disallowed deduction with respect to the partnership interest.

[T.D. 8455, 57 FR 61321, Dec. 24, 1992]

§ 1.179–4 Definitions.

The following definitions apply for purposes of section 179 and §§1.179–1 through 1.179–6:

(a) *Section 179 property.* The term *section 179 property* means any tangible property described in section 179(d)(1) that is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in §1.179–2(c)(6)). For taxable years beginning after 2002 and before 2008, the term *section 179 property* includes computer software described in section 179(d)(1) that is placed in service by the taxpayer in a taxable year beginning after 2002 and before 2008 and is acquired by purchase for use in the active conduct of the taxpayer's trade or business (as described in 1.179–2(c)(6)). For purposes of this paragraph (a), the term *trade or business* has the same meaning as in section 162 and the regulations under section 162.

(b) *Section 38 property.* The term *section 38 property* shall have the same meaning assigned to it in section 48(a) and the regulations thereunder.

(c) *Purchase.* (1)(i) Except as otherwise provided in paragraph (d)(2) of this section, the term *purchase* means any acquisition of the property, but only if all the requirements of paragraphs (c)(1) (ii), (iii), and (iv) of this section are satisfied.

(ii) Property is not acquired by purchase if it is acquired from a person whose relationship to the person acquiring it would result in the disallowance of losses under section 267 or 707(b). The property is considered not acquired by purchase only to the extent that losses would be disallowed under section 267 or 707(b). Thus, for example, if property is purchased by a husband and wife jointly from the husband's father, the property will be treated as not acquired by purchase only to the extent of the husband's interest in the property. However, in applying the rules of section 267 (b) and (c) for this purpose, section 267(c)(4) shall be treated as providing that the family of an individual will include only his spouse, ancestors, and lineal descendants. For example, a purchase of property from a corporation by a taxpayer who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of such corporation does not qualify as a purchase under section 179(d)(2); nor does the purchase of property by a husband from his wife. However, the purchase of section 179 property by a taxpayer from his brother or sister does qualify as a purchase for purposes of section 179(d)(2).

(iii) The property is not acquired by purchase if acquired from a component member of a controlled group of corporations (as defined in paragraph (g) of this section) by another component member of the same group.

(iv) The property is not acquired by purchase if the basis of the property in the hands of the person acquiring it is determined in whole or in part by reference to the adjusted basis of such property in the hands of the person from whom acquired, is determined under section 1014(a), relating to property acquired from a decedent, or is determined under section 1022, relating to property acquired from certain decedents who died in 2010. For example, property acquired by gift or bequest does not qualify as property acquired by purchase for purposes of section 179(d)(2); nor does property received in a corporate distribution the basis of which is determined under section 301(d)(2)(B), property acquired by a corporation in a transaction to which section 351 applies, property acquired by a partnership through contribution (section 723), or property received in a partnership distribution which has a carryover basis under section 732(a)(1).

(2) Property deemed to have been acquired by a new target corporation as a result of a section 338 election (relating to certain stock purchases treated as asset acquisitions) or a section 336(e) election (relating to certain stock dispositions treated as asset transfers) made for a disposition described in §1.336–2(b)(1) will be considered acquired by purchase.

(d) *Cost.* The cost of section 179 property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the taxpayer. For example, X Corporation purchases a new drill press costing $10,000 in November 1984 which qualifies as section 179 property, and is granted a trade-in allowance of $2,000 on its old drill press. The old drill press had a basis of $1,200. Under the provisions of sections 1012 and 1031(d), the basis of the new drill press is $9,200 ($1,200 basis of oil drill press plus cash expended of $8,000). However, only $8,000 of the basis of the new drill press qualifies as cost for purposes of the section 179 expense deduction; the remaining $1,200 is not part of the cost because it is determined by reference to the basis of the old drill press.

(e) *Placed in service*. The term *placed in service* means the time that property is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function, whether for use in a trade or business, for the production of income, in a tax-exempt activity, or in a personal activity. See §1.46–3(d)(2) for examples regarding when property shall be considered in a condition or state of readiness and availability for a specifically assigned function.

(f) *Controlled group of corporations and component member of controlled group*. The terms *controlled group of corporations* and *component member* of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1).

[T.D. 8121, 52 FR 413, Jan. 6, 1987. Redesignated by T.D. 8455, 57 FR 61321, 61323, Dec. 24, 1992, as amended by T.D. 9146, 69 FR 46984, Aug. 4, 2004; T.D. 9209, 70 FR 40191, July 13, 2005; T.D. 9811, 82 FR 6236, Jan. 19, 2016; T.D. 9874, 84 FR 50149, Sept. 24, 2019]

§ 1.179–5 Time and manner of making election.

(a) *Election*. A separate election must be made for each taxable year in which a section 179 expense deduction is claimed with respect to section 179 property. The election under section 179 and §1.179–1 to claim a section 179 expense deduction for section 179 property shall be made on the taxpayer's first income tax return for the taxable year to which the election applies (whether or not the return is timely) or on an amended return filed within the time prescribed by law (including extensions) for filing the return for such taxable year. The election shall be made by showing as a separate item on the taxpayer's income tax return the following items:

(1) The total section 179 expense deduction claimed with respect to all section 179 property selected, and

(2) The portion of that deduction allocable to each specific item.

The person shall maintain records which permit specific identification of each piece of section 179 property and reflect how and from whom such property was acquired and when such property was placed in service. However, for this purpose a partner (or an S corporation shareholder) treats partnership (or S corporation) section 179 property for which section 179 expenses are allocated from a partnership (or an S corporation) as one item of section 179 property. The election to claim a section 179 expense deduction under this section, with respect to any property, is irrevocable and will be binding on the taxpayer with respect to such property for the taxable year for which the election is made and for all subsequent taxable years, unless the Commissioner consents to the revocation of the election. Similarly, the selection of section 179 property by the taxpayer to be subject to the expense deduction and apportionment scheme must be adhered to in computing the taxpayer's taxable income for the taxable year for which the election is made and for all subsequent taxable years, unless consent to change is given by the Commissioner.

(b) *Revocation*. Any election made under section 179, and any specification contained in such election, may not be revoked except with the consent of the Commissioner. Such consent will be granted only in extraordinary circumstances. Requests for consent must be filed with the Commissioner of Internal Revenue, Washington, DC 20224. The request must include the name, address, and taxpayer identification number of the taxpayer and must be signed by the taxpayer or his duly authorized representative. It must be accompanied by a statement showing the year and property involved, and must set forth in detail the reasons for the request.

(c) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2008*—(1) *In general*. For any taxable year beginning after 2002 and before 2008, a taxpayer is permitted to make or revoke an election under section 179 without the consent of the Commissioner on an amended Federal tax return for that taxable year. This amended return must be filed within the time prescribed by law for filing an amended return for such taxable year.

(2) *Election*—(i) *In general.* For any taxable year beginning after 2002 and before 2008, a taxpayer is permitted to make an election under section 179 on an amended Federal tax return for that taxable year without the consent of the Commissioner. Thus, the election under section 179 and § 1.179–1 to claim a section 179 expense deduction for section 179 property may be made on an amended Federal tax return for the taxable year to which the election applies. The amended Federal tax return must include the adjustment to taxable income for the section 179 election and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the item of section 179 property to which the election pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

(ii) *Specifications of elections.* Any election under section 179 must specify the items of section 179 property and the portion of the cost of each such item to be taken into account under section 179(a). Any election under section 179 must comply with the specification requirements of section 179(c)(1)(A), § 1.179–1(b), and § 1.179–5(a). If a taxpayer elects to expense only a portion of the cost basis of an item of section 179 property for a taxable year beginning after 2002 and before 2008 (or did not elect to expense any portion of the cost basis of the item of section 179 property), the taxpayer is permitted to file an amended Federal tax return for that particular taxable year and increase the portion of the cost of the item of section 179 property to be taken into account under section 179(a) (or elect to expense any portion of the cost basis of the item of section 179 property if no prior election was made) without the consent of the Commissioner. Any such increase in the amount expensed under section 179 is not deemed to be a revocation of the prior election for that particular taxable year.

(3) *Revocation*—(i) *In general.* Section 179(c)(2) permits the revocation of an entire election or specification, or a portion of the selected dollar amount of a specification. The term *specification* in section 179(c)(2) refers to both the selected specific item of section 179 property subject to a section 179 election and the selected dollar amount allocable to the specific item of section 179 property. Any portion of the cost basis of an item of section 179 property subject to an election under section 179 for a taxable year beginning after 2002 and before 2008 may be revoked by the taxpayer without the consent of the Commissioner by filing an amended Federal tax return for that particular taxable year. The amended Federal tax return must include the adjustment to taxable income for the section 179 revocation and any collateral adjustments to taxable income or to the tax liability (for example, allowable depreciation in that taxable year for the item of section 179 property to which the revocation pertains). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years. Reducing or eliminating a specified dollar amount for any item of section 179 property with respect to any taxable year beginning after 2002 and before 2008 results in a revocation of that specified dollar amount.

(ii) *Effect of revocation.* Such revocation, once made, shall be irrevocable. If the selected dollar amount reflects the entire cost of the item of section 179 property subject to the section 179 election, a revocation of the entire selected dollar amount is treated as a revocation of the section 179 election for that item of section 179 property and the taxpayer is unable to make a new section 179 election with respect to that item of property. If the selected dollar amount is a portion of the cost of the item of section 179 property, revocation of a selected dollar amount shall be treated as a revocation of only that selected dollar amount. The revoked dollars cannot be the subject of a new section 179 election for the same item of property.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Taxpayer, a sole proprietor, owns and operates a jewelry store. During 2003, Taxpayer purchased and placed in service two items of section 179 property—a cash register costing $4,000 (5-year MACRS property) and office furniture costing $10,000 (7-year MACRS property). On his 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the cash register and, with respect to the office furniture, claimed the depreciation allowable. In November 2004, Taxpayer determines it would have been more advantageous to have made an election under section 179 to expense the full cost of the office furniture rather than the cash register. Pursuant to paragraph (c)(1) of this section, Taxpayer is permitted to file an amended Federal tax return for 2003 revoking the section 179 election for the cash register, claiming the depreciation allowable in 2003 for the cash register, and making an election to expense under section 179 the cost of the office furniture. The amended return must include an adjustment for the depreciation previously claimed in 2003 for the office furniture, an adjustment for the depreciation allowable in 2003 for the cash register, and any other collateral adjustments to taxable income or to the tax liability. In addition, once Taxpayer revokes the section 179 election for the entire cost basis of the cash register, Taxpayer can no longer expense under section 179 any portion of the cost of the cash register.

Example 2. Taxpayer, a sole proprietor, owns and operates a machine shop that does specialized repair work on industrial equipment. During 2003, Taxpayer purchased and placed in service one item of section 179 property—a milling machine costing $135,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 $5,000 of the cost of the milling machine and claimed allowable depreciation on the remaining cost. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have elected to expense $100,000 of the cost of the milling machine on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003, increasing the amount of the cost of the milling machine that is to be taken into account under section 179(a) to $100,000, decreasing the depreciation allowable in 2003 for the milling machine, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, increasing the amount of the cost of the milling machine to be taken into account under section 179(a) supplements the portion of the cost of the milling machine that was already taken into account by the original section 179 election made on the 2003 Federal tax return and no revocation of any specification with respect to the milling machine has occurred.

Example 3. Taxpayer, a sole proprietor, owns and operates a real estate brokerage business located in a rented storefront office. During 2003, Taxpayer purchases and places in service two items of section 179 property—a laptop computer costing $2,500 and a desktop computer costing $1,500. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 the full cost of the laptop computer and the full cost of the desktop computer. Subsequently, Taxpayer determines it would have been to Taxpayer's advantage to have originally elected to expense under section 179 only $1,500 of the cost of the laptop computer on Taxpayer's 2003 Federal tax return. In November 2004, Taxpayer files an amended Federal tax return for 2003 reducing the amount of the cost of the laptop computer that was taken into account under section 179(a) to $1,500, claiming the depreciation allowable in 2003 on the remaining cost of $1,000 for that item, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(3)(ii) of this section, the $1,000 reduction represents a revocation of a portion of the selected dollar amount and no portion of those revoked dollars may be the subject of a new section 179 election for the laptop computer.

Example 4. Taxpayer, a sole proprietor, owns and operates a furniture making business. During 2003, Taxpayer purchases and places in service one item of section 179 property—an industrial-grade cabinet table saw costing $5,000. On Taxpayer's 2003 Federal tax return filed on April 15, 2004, Taxpayer elected to expense under section 179 $3,000 of the cost of the saw and, with respect to the remaining $2,000 of the cost of the saw, claimed the depreciation allowable. In November 2004, Taxpayer files an amended Federal tax return for 2003 revoking the selected $3,000 amount for the saw, claiming the depreciation allowable in 2003 on the $3,000 cost of the saw, and making any other collateral adjustments to taxable income or to the tax liability. Subsequently, in December 2004, Taxpayer files a second amended Federal tax return for 2003 selecting a new dollar amount of $2,000 for the saw, including an adjustment for the depreciation previously claimed in 2003 on the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Pursuant to paragraph (c)(2)(ii) of this section, Taxpayer is permitted to select a new selected dollar amount to expense under section 179 encompassing all or a part of the initially non-elected portion of the cost of the elected item of section 179 property. However, no portion of the revoked $3,000 may be the subject of a new section 179 dollar amount selection for the saw. In December 2005, Taxpayer files a third amended Federal tax return for 2003 revoking the entire selected $2,000 amount with respect to the saw, claiming the depreciation allowable in 2003 for the $2,000, and making any other collateral adjustments to taxable income or to the tax liability. Because Taxpayer elected to expense, and subsequently revoke, the entire cost basis of the saw, the section 179 election for the saw has been revoked and Taxpayer is unable to make a new section 179 election with respect to the saw.

(d) *Election or revocation must not be made in any other manner.* Any election or revocation specified in this section must be made in the manner prescribed in paragraphs (a), (b), and (c) of this section. Thus, this election or revocation must not be made by the taxpayer in any other manner (for example, an election or a revocation of an election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting), except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin.

[T.D. 8121, 52 FR 414, Jan. 6, 1987. Redesignated by T.D. 8455, 57 FR 61321, 61323, Dec. 24, 1992, as amended by T.D. 9146, 69 FR 46984, Aug. 4, 2004; T.D. 9209, 70 FR 40191, July 13, 2005]

§ 1.179–6 Effective/applicability dates.

(a) *In general.* Except as provided in paragraphs (b), (c), (d), and (e) of this section, the provisions of §§ 1.179–1 through 1.179–5 apply for property placed in service by the taxpayer in taxable years ending after January 25, 1993. However, a taxpayer may apply the provisions of §§ 1.179–1 through 1.179–5 to property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993. Otherwise, for property placed in service by the taxpayer after December 31, 1986, in taxable years ending on or before January 25, 1993, the final regulations under section 179 as in effect for the year the property was placed in service apply, except to the extent modified by the changes made to section 179 by the Tax Reform Act of 1986 (100 Stat. 2085), the Technical and Miscellaneous Revenue Act of 1988 (102 Stat. 3342) and the Revenue Reconciliation Act of 1990 (104 Stat. 1388–400). For that property, a taxpayer may apply any reasonable method that clearly reflects income in applying the changes to section 179, provided the taxpayer consistently applies the method to the property.

(b) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2008.* The provisions of § 1.179–2(b)(1) and (b)(2)(ii), the second sentence of § 1.179–4(a), and the provisions of § 1.179–5(c), reflecting changes made to section 179 by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (117 Stat. 752) and the American Jobs Creation Act of 2004 (118 Stat. 1418), apply for property placed in service in taxable years beginning after 2002 and before 2008.

(c) *Application of § 1.179–5(d).* Section 1.179–5(d) applies on or after July 12, 2005.

(d) *Application of § 1.179–4(c)(1)(iv).* The provisions of § 1.179–4(c)(1)(iv) relating to section 1022 are effective on and after January 19, 2017.

(e) *Application of § 1.179–4(c)(2)*–(1) *In general.* Except as provided in paragraphs (e)(2) and (3) of this section, the provisions of § 1.179–4(c)(2) relating to section 336(e) are applicable on or after September 24, 2019.

(2) *Early application of § 1.179–4(c)(2).* A taxpayer may choose to apply the provisions of § 1.179–4(c)(2) relating to section 336(e) for the taxpayer's taxable years ending on or after September 28, 2017.

(3) *Early application of regulation project REG–104397–18.* A taxpayer may rely on the provisions of § 1.179–4(c)(2) relating to section 336(e) in regulation project REG–104397–18 (2018–41 I.R.B. 558) (see § 601.601(d)(2)(ii)(b) of this chapter) for the taxpayer's taxable years ending on or after September 28, 2017, and ending before September 24, 2019.

[T.D. 9146, 69 FR 46985, Aug. 4, 2004. Redesignated and amended by T.D. 9209, 70 FR 40192, July 13, 2005; T.D. 9811, 82 FR 6236, Jan. 19, 2017; T.D. 9874, 84 FR 50149, Sept. 24, 2019]

§ 1.179A–1 [Reserved]

§ 1.179B–1T Deduction for capital costs incurred in complying with Environmental Protection Agency sulfur regulations (temporary).

(a) *Scope and definitions*—(1) *Scope.* This section provides the rules for determining the amount of the deduction allowable under section 179B(a) for qualified capital costs paid or incurred by a small business refiner to comply with the highway diesel fuel sulfur control requirements of the Environmental Protection Agency (EPA). This section also provides rules for making elections under section 179B.

(2) *Definitions.* For purposes of section 179B and this section, the following definitions apply:

(i) The *applicable EPA regulations* are the EPA regulations establishing the highway diesel fuel sulfur control program (40 CFR part 80, subpart I).

(ii) The *average daily domestic refinery run* for a refinery is the lesser of—

(A) The total amount of crude oil input (in barrels) to the refinery's domestic processing units during the 1-year period ending on December 31, 2002, divided by 365; or

(B) The total amount of refined petroleum product (in barrels) produced by the refinery's domestic processing units during such 1-year period divided by 365.

(iii) The *aggregate average domestic daily refinery run* for a refiner is the sum of the average daily domestic refinery runs for all refineries that were owned by the refiner or a related person on April 1, 2003.

(iv) *Cooperative owner* is a person that—

(A) Directly holds an ownership interest in a cooperative small business refiner, as defined in paragraph (a)(2)(v) of this section; and

(B) Is a cooperative to which part 1 of subchapter T of the Internal Revenue Code (Code) applies.

(v) *Cooperative small business refiner* is a small business refiner that is a cooperative to which part 1 of subchapter T of the Code applies.

(vi) *Low sulfur diesel fuel* has the meaning prescribed in section 45H(c)(5).

(vii) *Qualified capital costs* are qualified costs as defined in section 45H(c)(2) that are properly chargeable to capital account.

(viii) *Related person* has the meaning prescribed in section 613A(d)(3) and the regulations under section 613A(d)(3).

(ix) *Small business refiner* has the meaning prescribed in section 45H(c)(1).

(b) *Section 179B deduction*—(1) *In general.* Section 179B(a) allows a deduction with respect to the qualified capital costs paid or incurred by a small business refiner (the section 179B deduction). The deduction is allowable with respect to the qualified capital costs paid or incurred during a taxable year only if the small business refiner makes an election under paragraph (d) of this section for the taxable year. The certification requirement in section 45H(e) (relating to the certification required to support a credit under section 45H) does not apply for purposes of the section 179B deduction. Accordingly, the section 179B deduction is allowable with respect to the qualified capital costs of an electing small business refiner even if the refiner never obtains a certification under section 45H(e) with respect to those costs.

(2) *Computation of section 179B deduction*—(i) *In general.* Except as provided in paragraphs (b)(2)(ii) and (c)(3) of this section, a small business refiner that makes an election under paragraph (d) of this section for a taxable year is allowed a section 179B deduction in an amount equal to 75 percent of qualified capital costs that are paid or incurred by the small business refiner during the taxable year.

(ii) *Reduced percentage.* A small business refiner's section 179B deduction is reduced if the refiner's aggregate average daily domestic refinery run is in excess of 155,000 barrels. In that case, the number of percentage points used in computing the deduction under paragraph (b)(2)(i) of this section (75) is reduced (not below zero) by the product of 75 and the ratio of the excess barrels to 50,000 barrels.

(3) *Example.* The application of this paragraph (b) is illustrated by the following example:

Example. (i) A, an accrual method taxpayer, is a small business refiner with a taxable year ending December 31. On April 1, 2003, A owns a refinery with an average daily domestic refinery run (that is, an average daily run during calendar year 2002) of 100,000 barrels and a person related to A owns a refinery with an average daily domestic refinery run of 85,000 barrels. These are the only domestic refineries owned by A and persons related to A. A's aggregate average daily domestic refinery run for the two refineries is 185,000 barrels. A incurs qualified capital costs of $10 million in the taxable year ended December 31, 2007. The costs are incurred with respect to property that is placed in service in year 2008. A makes the election under paragraph (d) of this section for the 2007 taxable year.

(ii) Because A's aggregate average daily domestic refinery run is 185,000 barrels, the percentage of the qualified capital costs that is deductible under section 179B(a) is reduced from 75 percent to 30 percent (75 percent reduced by 75 percent multiplied by 0.6 ((185,000 barrels minus 155,000 barrels)/50,000 barrels)). Thus, for 2007, A's deduction under section 179B(a) is $3,000,000 ($10,000,000 qualified capital costs multiplied by .30).

(c) *Effect on basis*—(1) *In general.* If qualified capital costs are included in the basis of property, the basis of the property is reduced by the amount of the section 179B deduction allowed with respect to such costs.

(2) *Treatment as depreciation.* If qualified capital costs are included in the basis of depreciable property, the amount of the section 179B deduction allowed with respect to such costs is treated as a depreciation deduction for purposes of section 1245.

(d) *Election to deduct qualified capital costs*—(1) *In general*—(i) *Section 179B election.* This paragraph (d) prescribes rules for the election to deduct the qualified capital costs paid or incurred by a small business refiner during a taxable year (the section 179B election). A small business refiner making the section 179B election for a taxable year consents to, and agrees to apply, all of the provisions of section 179B and this section to qualified capital costs paid or incurred by the refiner during the taxable year. The section 179B election for a taxable year applies with respect to all qualified capital costs paid or incurred by the small business refiner during that taxable year.

(ii) *Year-by-year election.* A separate section 179B election must be made for each taxable year in which the taxpayer seeks to deduct qualified capital costs under section 179B. A small business refiner may make the section 179B election for some taxable years and not for other taxable years.

(iii) *Elections for cooperative small business refiners.* See paragraph (e) of this section for the rules applicable to the election provided under section 179B(e), relating to the election to allocate the section 179B deduction to cooperative owners of a cooperative small business refiner (the section 179B(e) election).

(2) *Time and manner for making section 179B election*—(i) *Time for making election.* Except as provided in paragraph (d)(2)(iii) of this section, a taxpayer's section 179B election for a taxable year must be made by the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year.

(ii) *Manner of making election*—(A) *In general.* Except as provided in paragraph (d)(2)(iii) of this section, the section 179B election for a taxable year is made by claiming a section 179B deduction on the taxpayer's original Federal income tax return for the taxable year and attaching the statement described in paragraph (d)(2)(ii)(B) of this section to the return. The section 179B election with respect to qualified capital costs paid or incurred by a partnership is made by the partnership and the section 179B election with respect to qualified capital costs paid or incurred by an S corporation is made by the S corporation. In the case of qualified capital costs paid or incurred by the members of a consolidated group (within the meaning of §1.1502–1(h)), the section 179B election with respect to such costs is made for each member by the common parent of the group.

(B) *Information required in election statement.* The election statement attached to the taxpayer's return must contain the following information:

(*1*) The name and identification number of the small business refiner.

(*2*) The amount of the qualified capital costs paid or incurred during the taxable year for which the election is made.

(*3*) The aggregate average daily domestic refinery run (as determined under paragraph (a)(2)(iii) of this section).

(*4*) The date by which the small business refiner must comply with the applicable EPA regulations. If this date is not June 1, 2006, the statement also must explain why compliance is not required by June 1, 2006.

(*5*) The calculation of the section 179B deduction for the taxable year.

(*6*) For each property that will have its basis reduced on account of the section 179B deduction for the taxable year, a description of the property, the amount included in the basis of the property on account of qualified capital costs paid or incurred during the taxable year, and the amount of the basis reduction to that property on account of the section 179B deduction for the taxable year.

(iii) Except as otherwise expressly provided by the Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, a section 179B election is valid only if made at the time and in the manner prescribed in this paragraph (d)(2). For example, except as otherwise expressly provided, the 179B election cannot be made for a taxable year to which this section applies through a request under section 446(e) to change the taxpayer's method of accounting.

(3) *Revocation of election.* An election made under this paragraph (d) may not be revoked without the prior written consent of the Commissioner of Internal Revenue. To seek the Commissioner's consent, the taxpayer must submit a request for a private letter ruling (for further guidance, see, for example, Rev. Proc. 2008–1 (2008–1 IRB 1) and §601.601(d)(2)(ii)(*b*) of this chapter).

(4) *Failure to make election.* If a small business refiner does not make the section 179B election for a taxable year at the time and in the manner prescribed in paragraph (d)(2) of this section, no deduction is allowed for the qualified capital costs that the refiner paid or incurred during the year. Instead these qualified capital costs are chargeable to a capital account in that taxable year, the basis of the property to which these costs are capitalized is not reduced on account of section 179B, and the amount of depreciation allowable for the property attributable to these costs is determined by reference to these costs unreduced by section 179B.

(5) *Elections for taxable years ending before June 26, 2008.* This section does not apply to section 179B elections for taxable years ending before June 26, 2008. The rules for making the section 179B election for a taxable year ending before June 26, 2008 are provided in Notice 2006–47 (2006–20 IRB 892). See §601.601(d)(2)(ii)(*b*) of this chapter.

(e) *Election under section 179B(e) to allocate section 179B deduction to cooperative owners*—(1) *In general.* A cooperative small business refiner may elect to allocate part or all of its cooperative owners' ratable shares of the section 179B deduction for a taxable year to the cooperative owners (the section 179B(e) election). The section 179B deduction allocated to a cooperative owner is equal to the cooperative owner's ratable share of the total section 179B deduction allocated. A cooperative owner's ratable share is determined for this purpose on the basis of the cooperative owner's ownership interest in the cooperative small business refiner during the cooperative small business refiner's taxable year. If the cooperative owners' interests vary during the year, the cooperative small business refiner shall determine the owners' ratable shares under a consistently applied method that reasonably takes into account the owners' varying interests during the taxable year.

(2) *Cooperative small business refiner denied section 1382 deduction for allocated portion.* In computing taxable income under section 1382, a cooperative small business refiner must reduce its section 179B deduction for the taxable year by an amount equal to the section 179B deduction allocated under this paragraph (e) to the refiner's cooperative owners for the taxable year.

(3) *Time and manner for making election*—(i) *Time for making election.* The section 179B(e) election for a taxable year must be made by the due date (including extensions) for filing the cooperative small business refiner's Federal income tax return for the taxable year.

(ii) *Manner of making election.* The section 179B(e) election for a taxable year is made by attaching a statement to the cooperative small business refiner's Federal income tax return for the taxable year. The election statement must contain the following information:

(A) The name and identification number of the cooperative small business refiner.

(B) The amount of the section 179B deduction allowable to the cooperative small business refiner for the taxable year (determined before the application of section 179B(e) and this paragraph (e)).

(C) The name and identification number of each cooperative owner to which the cooperative small business refiner is allocating all or some of the section 179B deduction.

(D) The amount of the section 179B deduction that is allocated to each cooperative owner listed in response to paragraph (e)(3)(ii)(C) of this section.

(4) *Irrevocable election.* A section 179B(e) election for a taxable year, once made, is irrevocable for that taxable year.

(5) *Written notice to owners.* A cooperative small business refiner that makes a section 179B(e) election for a taxable year must notify each cooperative owner of the amount of the section 179B deduction that is allocated to that cooperative owner. This notification must be provided in a written notice that is mailed by the cooperative small business refiner to its cooperative owner before the due date (including extensions) of the cooperative small business refiner's Federal income tax return for the election year. In addition, the cooperative small business refiner must report the amount of the cooperative owner's section 179B deduction on Form 1099–PATR, ''Taxable Distributions Received From Cooperatives,'' issued to the cooperative owner. If Form 1099–PATR is revised or renumbered, the amount of the cooperative owner's section 179B deduction must be reported on the revised or renumbered form.

(f) *Effective/applicability date*—(1) *In general.* This section applies to taxable years ending on or after June 26, 2008.

(2) *Application to taxable years ending before June 26, 2008.* A small business refiner may apply this section to a taxable year ending before June 26, 2008, provided that the small business refiner applies all provisions in this section, with the modifications described in paragraph (f)(3) of this section, to the taxable year.

(3) *Modifications applicable to taxable years ending before June 26, 2008.* The following modifications to the rules of this section apply to a small business refiner that applies those rules to a taxable year ending before *June 26, 2008*:

(i) *Rules relating to section 179B election.* The section 179B election for a taxable year ending before *June 26, 2008* may be made under the rules provided in Notice 2006–47, rather than under the rules set forth in paragraph (d) of this section.

(ii) *Rules relating to section 179B(e) election.* A section 179B(e) election for a taxable year ending before *June 26, 2008* will be treated as satisfying the requirements of paragraph (f) if the cooperative small business refiner has calculated its tax liability in a manner consistent with the election and has used any reasonable method consistent with the principles of section 179B(e) to inform the Internal Revenue Service that an election has been made under section 179B(e) and to inform cooperative owners of the amount of the section 179B deduction they have been allocated.

(4) *Expiration date.* The applicability of §179B–1T expires on *June 24, 2011*.

[T.D. 9404, 73 FR 36422, June 27, 2008]

§ 1.179C–1 Election to expense certain refineries.

(a) *Scope and definitions*—(1) *Scope.* This section provides the rules for determining the deduction allowable under section 179C(a) for the cost of any qualified refinery property. The provisions of this section apply only to a taxpayer that elects to apply section 179C in the manner prescribed under paragraph (d) of this section.

(2) *Definitions.* For purposes of section 179C and this section, the following definitions apply:

(i) *Applicable environmental laws* are any applicable federal, state, or local environmental laws.

(ii) *Qualified fuels* has the meaning set forth in section 45K(c).

(iii) *Cost* is the unadjusted depreciable basis (as defined in §1.168(b)–1(a)(3), but without regard to the reduction in basis for any portion of the basis the taxpayer properly elects to treat as an expense under section 179C and this section) of the property.

(iv) *Throughput* is a volumetric rate measuring the flow of crude oil, qualified fuels, or, in the case of property placed in service after October 3, 2008, and before January 1, 2014, shale or tar sands, processed over a given period of time, typically referenced on the basis of barrels per calendar day.

(v) *Barrels per calendar day* is the amount of fuels that a facility can process under usual operating conditions, expressed in terms of capacity during a 24-hour period and reduced to account for down time and other limitations.

(vi) *United States* has the same meaning as that term is defined in section 7701(a)(9).

(b) *Qualified refinery property*—(1) *In general*. Qualified refinery property is any property that meets the requirements set forth in paragraphs (b)(2) through (b)(7) of this section.

(2) *Description of qualified refinery property*—(i) *In general*. Property that comprises any portion of a qualified refinery may be qualified refinery property. For purposes of section 179C and this section, a qualified refinery is any refinery located in the United States that—

(A) In the case of property placed in service after August 8, 2005, and on or before October 3, 2008, is designed to serve the primary purpose of processing liquid fuel from crude oil or qualified fuels; or

(B) In the case of property placed in service after October 3, 2008, and before January 1, 2014, is designed to serve the primary purpose of processing liquid fuel from crude oil, qualified fuels, or directly from shale or tar sands.

(ii) *Nonqualified refinery property*. Refinery property is not qualified refinery property for purposes of this paragraph (b)(2) if—

(A) The primary purpose of the refinery property is for use as a topping plant, asphalt plant, lube oil facility, crude or product terminal, or blending facility; or

(B) The refinery property is built solely to comply with consent decrees or projects mandated by Federal, State, or local governments.

(3) *Original use*—(i) *In general*. For purposes of the deduction allowable under section 179C(a), refinery property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer. Except as provided in paragraph (b)(3)(ii) of this section, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, if a taxpayer incurs capital expenditures to recondition or rebuild property acquired or owned by the taxpayer, only the capital expenditures incurred by the taxpayer to recondition or rebuild the property acquired or owned by the taxpayer satisfy the original use requirement. However, the cost of reconditioned or rebuilt property acquired by a taxpayer does not satisfy the original use requirement. Whether property is reconditioned or rebuilt property is a question of fact. For purposes of this paragraph (b)(3)(i), acquired or self-constructed property that contains used parts will be treated as reconditioned or rebuilt only if the cost of the used parts is more than 20 percent of the total cost of the property.

(ii) *Sale-leaseback*. If any new portion of a qualified refinery is originally placed in service by a person after August 8, 2005, and is sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the taxpayer-lessor is considered the original user of the property.

(4) *Placed-in-service date*—(i) *In general*. Refinery property will meet the requirements of this paragraph (b)(4) if the property is placed in service by the taxpayer after August 8, 2005, and before January 1, 2014.

(ii) *Sale-leaseback*. If a new portion of refinery property is originally placed in service by a person after August 8, 2005, and is sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the leaseback.

(5) *Production capacity*—(i) *In general.* Refinery property is considered qualified refinery property if—

(A) It enables the existing qualified refinery to increase the total volume output, determined without regard to asphalt or lube oil, by at least 5 percent on an average daily basis;

(B) In the case of property placed in service after August 8, 2005, and on or before October 3, 2008, it enables the existing qualified refinery to increase the percentage of total throughput attributable to processing qualified fuels to a rate that is at least 25 percent of total throughput on an average daily basis; or

(C) In the case of property placed in service after October 3, 2008, and before January 1, 2014, it enables the existing qualified refinery to increase the percentage of total throughput attributable to processing qualified fuels, shale, or tar sands to a rate that is at least 25 percent of total throughput on an average daily basis.

(ii) *When production capacity is tested.* The production capacity requirement of this paragraph (b)(5) is determined as of the date the property is placed in service by the taxpayer. Any reasonable method may be used to determine the appropriate baseline for measuring capacity increases and to demonstrate and substantiate that the capacity of the existing qualified refinery has been sufficiently increased.

(iii) *Multi-stage projects.* In the case of multi-stage projects, a taxpayer must satisfy the reporting requirements of paragraph (f)(2) of this section, sufficient to establish that the production capacity requirements of this paragraph (b)(5) will be met as a result of the taxpayer's overall plan.

(6) *Applicable environmental laws*—(i) *In general.* The environmental compliance requirement applies only with respect to refinery property, or any portion of refinery property, that is placed in service after August 8, 2005. A refinery's failure to meet applicable environmental laws with respect to a portion of the refinery that was in service prior to August 8, 2005 will not disqualify a taxpayer from making the election under section 179C(a) with respect to otherwise qualifying refinery property.

(ii) *Waiver under the Clean Air Act.* Refinery property must comply with the Clean Air Act, notwithstanding any waiver received by the taxpayer under that Act.

(7) *Construction of property*—(i) *In general.* Qualified property will meet the requirements of this paragraph (b)(7) if no written binding contract for the construction of the property was in effect before June 14, 2005, and if—

(A) The construction of the property is subject to a written binding contract entered into before January 1, 2010;

(B) The property is placed in service before January 1, 2010; or

(C) In the case of self-constructed property, the construction of the property began after June 14, 2005, and before January 1, 2010.

(ii) *Definition of binding contract*—(A) *In general.* A contract is binding only if it is enforceable under state law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account.

(B) *Conditions.* A contract is binding even if subject to a condition, as long as the condition is not within the control of either party or the predecessor of either party. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions, or if any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding, notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract.

(C) *Options.* An option to either acquire or sell property is not a binding contract.

(D) *Supply agreements.* A binding contract does not include a supply or similar agreement if the payment amount and design specification of the property to be purchased have not been specified.

(E) *Components.* A binding contract to acquire one or more components of a larger property will not be treated as a binding contract to acquire the larger property. If a binding contract to acquire a component does not satisfy the requirements of this paragraph (b)(7), the component is not qualified refinery property.

(iii) *Self-constructed property*—(A) *In general.* Except as provided in paragraph (b)(7)(iii)(B) of this section, if a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for the production of income by the taxpayer), the construction of property rules in this paragraph (b)(7) are treated as met for qualified refinery property if the taxpayer begins manufacturing, constructing, or producing the property after June 14, 2005, and before January 1, 2010. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in paragraph (b)(7)(ii) of this section) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for the production of income) is considered to be manufactured, constructed, or produced by the taxpayer.

(B) *When construction begins.* For purposes of this paragraph (b)(7)(iii), construction of property generally begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances.

(C) *Components of self-constructed property*—(*1*) *Acquired components.* If a binding contract (as defined in paragraph (b)(7)(ii) of this section) to acquire a component of self-constructed property is in effect on or before June 14, 2005, the component does not satisfy the requirements of paragraph (b)(7)(i) of this section, and is not qualified refinery property. However, if construction of the self-constructed property begins after June 14, 2005, the self-constructed property may be qualified refinery property if it meets all other requirements of section 179C and this section (including paragraph (b)(7)(i) of this section), even though the component is not qualified refinery property. If the construction of self-constructed property begins before June 14, 2005, neither the self-constructed property nor any component related to the self-constructed property is qualified refinery property. If the component is acquired before January 1, 2010, but the construction of the self-constructed property begins after December 31, 2009, the component may qualify as qualified refinery property even if the self-constructed property is not qualified refinery property.

(*2*) *Self-constructed components.* If the manufacture, construction, or production of a component fails to meet any of the requirements of paragraph (b)(7)(iii) of this section, the component is not qualified refinery property. However, if the manufacture, construction, or production of a component fails to meet any of the requirements provided in paragraph (b)(7)(iii) of this section, but the construction of the self-constructed property begins after June 14, 2005, the self constructed property may qualify as qualified refinery property if it meets all other requirements of section 179C and this section (including paragraph (b)(7)(i) of this section). If the construction of the self-constructed property begins before June 14, 2005, neither the self-constructed property nor any components related to the self-constructed property are qualified refinery property. If the component was self-constructed before January 1, 2010, but the construction of the self-constructed property begins after December 31, 2009, the component may qualify as qualified refinery property, although the self-constructed property is not qualified refinery property.

(c) *Computation of expense deduction for qualified refinery property.* In general, the allowable deduction under paragraph (d) of this section for qualified refinery property is determined by multiplying by 50 percent the cost of the qualified refinery property paid or incurred by the taxpayer.

(d) *Election*—(1) *In general.* A taxpayer may make an election to deduct as an expense 50 percent of the cost of any qualified refinery property. A taxpayer making this election takes the 50 percent deduction for the taxable year in which the qualified refinery property is placed in service.

(2) *Time and manner for making election*—(i) *Time for making election.* An election specified in this paragraph (d) generally must be made not later than the due date (including extensions) for filing the original Federal income tax return for the taxable year in which the qualified refinery property is placed in service by the taxpayer.

(ii) *Manner of making election.* The taxpayer makes an election under section 179C(a) and this paragraph (d) by entering the amount of the deduction at the appropriate place on the taxpayer's timely filed original Federal income tax return for the taxable year in which the qualified refinery property is placed in service, and attaching a report as specified in paragraph (f) of this section to the taxpayer's timely filed original federal income tax return for the taxable year in which the qualified refinery property is placed in service.

(3) *Revocation of election*—(i) *In general.* An election made under section 179C(a) and this paragraph (d), and any specification contained in such election, may not be revoked except with the consent of the Commissioner of Internal Revenue.

(ii) *Revocation prior to the revocation deadline.* A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 179C(a) and this paragraph (d) if the taxpayer revokes the election before the revocation deadline. The revocation deadline is 24 months after the due date (including extensions) for filing the taxpayer's Federal income return for the taxable year for which the election applies. An election under section 179C(a) and this paragraph (d) is revoked by attaching a statement to an amended return for the taxable year for which the election applies. The statement must specify the name and address of the refinery for which the election applies and the amount deducted on the taxpayer's original Federal income tax return for the taxable year for which the election applies.

(iii) *Revocation after the revocation deadline.* An election under section 179C(a) and this paragraph (d) may not be revoked after the revocation deadline. The revocation deadline may not be extended under § 301.9100–1.

(iv) *Revocation by cooperative taxpayer.* A taxpayer that has made an election to allocate the section 179C deduction to cooperative owners under section 179C(g) and paragraph (e) of this section may not revoke its election under section 179C(a).

(e) *Election to allocate section 179C deduction to cooperative owners*—(1) In *general.* If a cooperative taxpayer makes an election under section 179C(g) and this paragraph (e), the cooperative taxpayer may elect to allocate all, some, or none of the deduction allowable under section 179C(a) for that taxable year to the cooperative owner(s). This allocation is equal to the cooperative owner(s)' ratable share of the total amount allocated, determined on the basis of each cooperative owner's ownership interest in the cooperative taxpayer. For purposes of this section, a cooperative taxpayer is an organization to which part I of subchapter T applies, and in which another organization to which part I of subchapter T applies (cooperative owner) directly holds an ownership interest. No deduction shall be allowed under section 1382 for any amount allocated under this paragraph (e).

(2) *Time and manner for making election*—(i) *Time for making election.* A cooperative taxpayer must make the election under section 179C(g) and this paragraph (e) by the due date (including extensions) for filing the cooperative taxpayer's original Federal income tax return for the taxable year to which the cooperative taxpayer's election under section 179C(a) and paragraph (d) of this section applies.

(ii) *Manner of making election.* An election under this paragraph (e) is made by attaching to the cooperative taxpayer's timely filed Federal income tax return for the taxable year (including extensions) to which the cooperative taxpayer's election under section 179C(a) and paragraph (d) of this section applies a statement providing the following information:

(A) The name and taxpayer identification number of the cooperative taxpayer.

(B) The amount of the deduction allowable to the cooperative taxpayer for the taxable year to which the election under section 179C(a) and paragraph (d) of this section applies.

(C) The name and taxpayer identification number of each cooperative owner to which the cooperative taxpayer is allocating all or some of the deduction allowable.

(D) The amount of the allowable deduction that is allocated to each cooperative owner listed in paragraph (e)(2)(ii)(C) of this section.

(3) *Written notice to owners.* If any portion of the deduction allowable under section 179C(a) is allocated to a cooperative owner, the cooperative taxpayer must notify the cooperative owner of the amount of the deduction allocated to the cooperative owner in a written notice, and on Form 1099–PATR, ''Taxable Distributions Received from Cooperatives.'' This notice must be provided on or before the due date (including extensions) of the cooperative taxpayer's original federal income tax return for the taxable year for which the cooperative taxpayer's election under section 179C(a) and paragraph (d) of this section applies.

(4) *Irrevocable election.* A section 179C(g) election, once made, is irrevocable.

(f) *Reporting requirement*—(1) *In general.* A taxpayer may not claim a deduction under section 179C(a) for any taxable year unless the taxpayer files a report with the Secretary containing information with respect to the operation of the taxpayer's refineries.

(2) *Information to be included in the report.* The taxpayer must specify—

(i) The name and address of the refinery;

(ii) Under which production capacity requirement under section 179C(e) and paragraph (b)(5)(i)(A), (B), and (C) of this section the taxpayer's qualified refinery qualifies;

(iii) Whether the refinery is qualified refinery property under section 179C(d) and paragraph (b)(2) of this section, sufficient to establish that the primary purpose of the refinery is to process liquid fuel from crude oil, qualified fuels, or directly from shale or tar sands.

(iv) The total cost basis of the qualified refinery property at issue for the taxpayer's current taxable year; and

(v) The depreciation treatment of the capitalized portion of the qualified refinery property.

(3) *Time and manner for submitting report*—(i) *Time for submitting report.* The taxpayer is required to submit the report specified in this paragraph (f) not later than the due date (including extensions) of the taxpayer's Federal income tax return for the taxable year in which the qualified refinery property is placed in service.

(ii) *Manner of submitting report.* The taxpayer must attach the report specified in this paragraph (f) to the taxpayer's timely filed original Federal income tax return for the taxable year in which the qualified refinery property is placed in service.

(g) *Effective/applicability date.* This section is applicable for taxable years ending on or after August 22, 2011. For taxable years ending before August 22, 2011, taxpayers may apply the proposed regulations published on July 9, 2008, or, in the alternative, may apply these final regulations.

[T.D. 9547, 76 FR 52558, Aug. 23, 2011]

§§ 1.179D–1–1.179D–2 [Reserved]

§ 1.179D–3 Rules relating to the increased deduction for prevailing wage and apprenticeship.

(a) In general. If any energy efficient commercial building property (as defined in section 179D(c)(1)), energy efficient building retrofit property (as defined in section 179D(f)(3)), or property installed pursuant to a qualified retrofit plan (as defined in section 179D(f)(2)) satisfies the requirements in paragraph (b) of this section, the applicable dollar value for determining the maximum amount of the deduction determined under section 179D(b)(2) is the increased amount described in section

179D(b)(3)(A). For purposes of this section, installation means those activities described in §§1.45–7(d)(3) and 1.45–8(g)(1) that are performed with respect to energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan within the meaning of section 179D before such property is placed in service.

(b) *Certain energy efficient commercial building property requirements.* Energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan satisfies the requirements of this paragraph (b) if it is one of the following—

(1) Property the installation of which began prior to January 29, 2023; or

(2) Property that meets the prevailing wage requirements of section 45(b)(7) of the Code and §1.45–7, the apprenticeship requirements of section 45(b)(8) of the Code and §1.45–8, and the recordkeeping and reporting requirements of §1.45–12, all with respect to the installation of any property.

(c) *Applicability date.* This section applies to energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan installed in taxable years ending after June 25, 2024, and the installation of which begins after June 25, 2024. Taxpayers may apply this section to energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan installed in taxable years ending on or before June 25, 2024, and energy efficient commercial building property, energy efficient building retrofit property, or property installed pursuant to a qualified retrofit plan installed in taxable years ending after June 25, 2024, the installation of which begins before June 25, 2024, provided that taxpayers follow this section in its entirety and in a consistent manner.

[T.D. 9998, 89 FR 53272, June 25, 2024]

§ 1.180–1 Expenditures by farmers for fertilizer, etc.

(a) *In general.* A taxpayer engaged in the business of farming may elect, for any taxable year beginning after December 31, 1959, to treat as deductible expenses those expenditures otherwise chargeable to capital account which are paid or incurred by him during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, and those expenditures otherwise chargeable to capital account paid or incurred for the application of such items and materials to such land. No election is required to be made for those expenditures which are not capital in nature. Section 180, §1.180–2, and this section are not applicable to those expenses which are deductible under section 162 and the regulations thereunder or which are subject to the method described in section 175 and the regulations thereunder.

(b) *Land used in farming.* For purposes of section 180(a) and of paragraph (a) of this section, the term *land used in farming* means land used (before or simultaneously with the expenditures described in such section and such paragraph) by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock. See section 180(b). Expenditures for the initial preparation of land never previously used for farming purposes by the taxpayer or his tenant (although chargeable to capital account) are not subject to the election. The principles stated in §§1.175–3 and 1.175–4 are equally applicable under this section in determining whether the taxpayer is engaged in the business of farming and whether the land is used in farming.

(74 Stat. 1001, 26 U.S.C. 180)

[T.D. 6548, 26 FR 1486, Feb. 22, 1961]

§ 1.180–2 Time and manner of making election and revocation.

(a) *Election.* The claiming of a deduction on the taxpayer's return for an amount to which section 180 applies for amounts (otherwise chargeable to capital account) expended for fertilizer, lime, etc., shall constitute an election under section 180 and paragraph (a) of §1.180–1. Such election shall be effective only for the taxable year for which the deduction is claimed.

(b) *Revocation.* Once the election is made for any taxable year such election may not be revoked without the consent of the district director for the district in which the taxpayer's return is required to be filed. Such requests for consent shall be in writing and signed by the taxpayer or his authorized representative and shall set forth:

(1) The name and address of the taxpayer;

(2) The taxable year to which the revocation of the election is to apply;

(3) The amount of expenditures paid or incurred during the taxable year, or portions thereof (where applicable), previously taken as a deduction on the return in respect of which the revocation of the election is to be applicable; and

(4) The reasons for the request to revoke the election.

(74 Stat. 1001, 26 U.S.C. 180)

[T.D. 6548, 26 FR 1486, Feb. 22, 1961]

§ 1.181–0 Table of contents.

This section lists the table of contents for §§ 1.181–1 through 1.181–6.

[T.D. 9551, 76 FR 60724, Sept. 30, 2011, as amended by T.D. 9603, 77 FR 72924, Dec. 7, 2012]

§ 1.181–1 Deduction for qualified film and television production costs.

(a) *Deduction*—(1) *In general.* (i) An owner (as defined in paragraph (a)(2) of this section) of any film or television production (production, as defined in § 1.181–3(b)) that the owner reasonably expects will be, upon completion, a qualified film or television production (as defined in § 1.181–3(a)) may elect to treat production costs paid or incurred by that owner (subject to the limits imposed under paragraph (b) of this section) as an expense that is deductible for the taxable year in which the costs are paid (for an owner who uses the cash receipts and disbursements method of accounting) or incurred (for an owner who uses an accrual method of accounting). The deduction under section 181 is subject to recapture if the owner's expectations are later determined to be inaccurate.

(ii) This section provides rules for determining the owner of a production, the production costs (as defined in paragraph (a)(3) of this section), the maximum amount of aggregate production costs (as defined in paragraph (a)(4) of this section) that may be paid or incurred for a pre-amendment production (as defined in paragraph (a)(5) of this section) for which the owner makes an election under section 181, and the maximum amount of aggregate production costs that may be claimed as a deduction for a post-amendment production (as defined in paragraph (a)(6) of this section) for which the owner makes an election under section 181. Section 1.181–2 provides rules for making the election under section 181. Section 1.181–3 provides definitions and rules concerning qualified film and television productions. Section 1.181–4 provides special rules, including rules for recapture of the deduction. Section 1.181–5 provides examples of the application of §§ 1.181–1 through 1.181–4, while § 1.181–6 provides the effective date of §§ 1.181–1 through 1.181–5.

(2) *Owner*. (i) For purposes of this section and §§ 1.181–2 through 1.181–6, an owner of a production is any person that is required under section 263A to capitalize the costs of producing the production into the cost basis of the production, or that would be required to do so if section 263A applied to that person.

(ii) Further, a person that acquires a finished or partially-finished production is treated as an owner of that production for purposes of this section and §§ 1.181–2 through 1.181–6, but only if the production is acquired prior to its initial release or broadcast (as defined in paragraph (a)(7) of this section). Moreover, a person that acquires only a limited license or right to exploit a production, or receives an interest or profit participation in a production, as compensation for services, is not an owner of the production for purposes of this section and §§ 1.181–2 through 1.181–6.

(3) *Production costs*. (i) For purposes of this section and §§ 1.181–2 through 1.181–6, the term *production costs* means all costs that are paid or incurred by an owner in producing a production that are required, absent the provisions of section 181, to be capitalized under section 263A, or that would be required to be capitalized if section 263A applied to the owner, and, if applicable, all costs that are paid or incurred by an owner in acquiring a production prior to its initial release or broadcast. Production costs include, but are not limited to, participations and residuals paid or incurred, compensation paid or incurred for services, compensation paid or incurred for property rights, non-compensation costs, and costs paid or incurred in connection with obtaining financing for the production (for example, premiums paid or incurred to obtain a completion bond for the production).

(ii) Production costs do not include costs paid or incurred to distribute or exploit a production (including advertising and print costs).

(iii) Production costs do not include the costs to prepare a new release or new broadcast of an existing production after the initial release or broadcast of the production (for example, the preparation of a DVD release of a theatrically-released film, or the preparation of an edited version of a theatrically-released film for television broadcast). Costs paid or incurred to prepare a new release or a new broadcast of a production after its initial release or broadcast, therefore, are not taken into account for purposes of paragraph (b)(1) of this section, and may not be deducted under this paragraph (a).

(iv) If a pre-amendment production is acquired from any person prior to its initial release or broadcast, the acquiring person must use as its initial aggregate costs the greater of—

(A) The cost of acquisition; or

(B) The seller's aggregate production costs.

(v) Production costs do not include costs that the owner has deducted or begun to amortize prior to the taxable year the owner makes an election under §1.181–2 for the production (for example, costs described in §1.181–2(a)(2)). These costs, however, are included in aggregate production costs to the extent they would have been treated as production costs by the owner notwithstanding this paragraph (a)(3)(v).

(4) *Aggregate production costs.* The term *aggregate production costs* means all production costs described in paragraph (a)(3) of this section paid or incurred by any person, whether paid or incurred directly by an owner or indirectly on behalf of an owner.

(5) *Pre-amendment production.* The term *pre-amendment production* means a qualified film or television production commencing after October 22, 2004, and before January 1, 2008.

(6) *Post-amendment production.* The term *post-amendment production* means a qualified film or television production commencing on or after January 1, 2008.

(7) *Initial release or broadcast.* Solely for purposes of this section and §§1.181–2 through 1.181–6, the term *initial release or broadcast* means the first commercial exhibition or broadcast of a production to an audience. However, the term ''initial release or broadcast'' does not include limited exhibition prior to commercial exhibition to general audiences if the limited exhibition is primarily for purposes of publicity, marketing to potential purchasers or distributors, determining the need for further production activity, or raising funds for the completion of production. For example, the term initial release or broadcast does not include exhibition to a test audience to determine the need for further production activity, or exhibition at a film festival for promotional purposes, if the exhibition precedes commercial exhibition to general audiences.

(8) *Special rule.* The provisions of this paragraph (a) apply notwithstanding the treatment of participations and residuals permitted under the income forecast method in section 167(g)(7)(D).

(b) *Limit on amount of aggregate production costs and amount of deduction*—(1) *In general*—(i) *Pre-amendment production.* Except as provided under paragraph (b)(2) of this section, no deduction is allowed under section 181 for any pre-amendment production, the aggregate production costs of which exceed $15,000,000. See also paragraph (a)(3)(iv) of this section. For a pre-amendment production for which the aggregate production costs do not exceed $15,000,000 (or, if applicable under paragraph (b)(2) of this section, $20,000,000), an owner may deduct under section 181 all of the production costs paid or incurred by that owner.

(ii) *Post-amendment production.* Section 181 permits a deduction for the first $15,000,000 (or, if applicable under paragraph (b)(2) of this section, $20,000,000) of the aggregate production costs of any post-amendment production.

(iii) *Special rules.* The owner's deduction under section 181 is limited to the owner's acquisition costs of the production plus any further production costs paid or incurred by the owner. The deduction under section 181 is not available for any portion of the acquisition costs, and any subsequent production costs, of a production with an initial release or broadcast that is prior to the date of acquisition.

(2) *Higher limit for productions in certain areas*—(i) *In general.* This section is applied by substituting $20,000,000 for $15,000,000 in paragraph (b)(1) of this section for any production the aggregate production costs of which are significantly paid or incurred in an area eligible for designation as—

(A) A low income community under section 45D; or

(B) A distressed county or isolated area of distress by the Delta Regional Authority established under 7 U.S.C. section 2009aa–1.

(ii) *Significantly paid or incurred for live action productions.* The aggregate production costs of a live action production are significantly paid or incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the aggregate production costs paid or incurred in connection with first-unit principal photography for the production are paid or incurred in connection with first-unit principal photography that takes place in such areas; or

(B) At least 50 percent of the total number of days of first-unit principal photography for the production consists of days during which first-unit principal photography takes place in such areas.

(iii) *Significantly paid or incurred for animated productions.* For purposes of an animated production, the aggregate production costs of the production are significantly paid or incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the aggregate production costs paid or incurred in connection with keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production are paid or incurred in connection with such activities that take place in such areas; or

(B) At least 50 percent of the total number of days of keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production consists of days during which such activities take place in such areas.

(iv) *Significantly paid or incurred for productions incorporating both live action and animation.* For purposes of a production incorporating both live action and animation, the aggregate production costs of the production are significantly paid or incurred within one or more areas specified in paragraph (b)(2)(i) of this section if—

(A) At least 20 percent of the aggregate production costs paid or incurred in connection with first-unit principal photography, keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production are paid or incurred in connection with such activities that take place in such areas; or

(B) At least 50 percent of the total number of days of first-unit principal photography, keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production consists of days during which such activities take place in such areas.

(v) *Establishing qualification.* An owner intending to utilize the higher aggregate production costs limit under this paragraph (b)(2) must establish qualification under this paragraph (b)(2).

(vi) *Allocation.* Solely for purposes of determining whether a production qualifies for the higher production cost limit (for pre-amendment productions) or deduction limit (for post-amendment productions) provided under this paragraph (b)(2), compensation to actors (as defined in §1.181–3(f)(1)), directors, producers, and other relevant production personnel (as defined in §1.181–3 (f)(2)) is allocated entirely to first-unit principal photography.

(c) *Effect on depreciation or amortization of a qualified film or television production*—(1) *Pre-amendment production.* Except as provided in §§1.181–1(a)(3)(v) and 1.181–2(a)(2), an owner that elects to deduct production costs under section 181 for a pre-amendment production may not deduct production costs for that production under any provision of the Internal Revenue Code other than section 181 unless the recapture requirements of §1.181–4(a) apply to the production.

(2) *Post-amendment production.* Amounts not allowable as a deduction under section 181 for a post-amendment production may be deducted under any other applicable provision of the Code.

[T.D. 9551, 76 FR 60724, Sept. 30, 2011, as amended by T.D. 9552, 76 FR 64817, Oct. 19, 2011; T.D. 9603, 77 FR 72924, Dec. 7, 2012]

§ 1.181–2 Election to deduct production costs.

(a) *Election*—(1) *In general.* Except as provided in paragraph (a)(2) of this section, an owner may make an election under section 181 to deduct production costs of a production only if that owner has not deducted in a previous taxable year any production costs for that production under any provision of the Internal Revenue Code (Code) other than section 181.

(2) *Exception.* An owner may make an election under section 181 despite prior deductions under any other provision of the Code for amortization of the costs of acquiring or developing screenplays, scripts, story outlines, motion picture production rights to books and

plays, and other similar properties for purposes of potential future development or production of a production, if such costs were paid or incurred before the first taxable year for which an election may be made under §1.181–2(b) and are included in aggregate production costs.

(b) *Time of making election*—(1) *In general*. The election to deduct production costs for a production under section 181 must be made by the due date (including any extension) for filing the owner's Federal income tax return for the first taxable year in which:

(i) Any aggregate production costs have been paid or incurred;

(ii) The owner reasonably expects (based on all of the facts and circumstances) that the production will be set for production and will, upon completion, be a qualified film or television production; and

(iii) For any pre-amendment production, the owner reasonably expects (based on all of the facts and circumstances) that the aggregate production costs paid or incurred for the pre-amendment production will, at no time, exceed the applicable aggregate production costs limit set forth under §1.181–1(b)(1)(i) or (b)(2).

(2) *Special rule*. If paragraph (b)(1) of this section is not satisfied until a taxable year subsequent to the taxable year in which any aggregate production costs were first paid or incurred, the owner must make the election for the taxable year in which paragraph (b)(1) of this section is first satisfied, and any production costs paid or incurred prior to the taxable year in which the owner makes the election and not deducted in a prior taxable year are treated as production costs (except costs described in §1.181–2(a)(2)) that are deductible under §1.181–1(a)(1)(i) for the taxable year paragraph (b)(1) of this section is first satisfied and the election is made.

(3) *Six-month extension*. See §301.9100–2 for a six-month extension of time to make the election in certain circumstances.

(c) *Manner of making election*—(1) *In general*. An owner must make the election under section 181 separately for each production. For a production owned by an entity, the election must be made by the entity. For example, if the production is owned by a partnership or S corporation, the partnership or S corporation must make the election.

(2) *Information required*—(i) *Initial election*. For each production to which the election applies, the owner must attach a statement to the owner's Federal income tax return for the taxable year of the election stating that the owner is making an election under section 181 and providing—

(A) The name (or other unique identifying designation) of the production;

(B) The date aggregate production costs were first paid or incurred for the production;

(C) The amount of aggregate production costs paid or incurred for the production during the taxable year (including costs described in §§1.181–1(a)(3)(v) and 1.181–2(b)(2));

(D) The amount of qualified compensation (as defined in §1.181–3(d)) paid or incurred for the production during the taxable year (including costs described in §1.181–2(b)(2));

(E) The amount of compensation (as defined in §1.181–3(c)) paid or incurred for the production during the taxable year (including costs described in §1.181–2(b)(2));

(F) If the owner expects that the aggregate production costs of the production will be significantly paid or incurred in (or, if applicable, if a significant portion of the total number of days of first-unit principal photography will occur in) one or more of the areas specified in §1.181–1(b)(2)(i), the identity of the area or areas, the amount of aggregate production costs paid or incurred (or the number of days of first-unit principal photography engaged in) for the applicable activities described in §1.181–1(b)(2)(ii), (b)(2)(iii), or (b)(2)(iv), as applicable, that took place within such areas (including costs described in §§1.181–1(a)(3)(v) and 1.181–2(b)(2)), and the aggregate production costs paid or incurred (or the total number of days of first-unit principal photography engaged in) for such activities (whether or not they took place in such areas), for the taxable year (including costs described in §§1.181–1(a)(3)(v) and 1.181–2(b)(2));

(G) A declaration that the owner reasonably expects (based on all of the facts and circumstances at the time the election is made) both that the production will be set for production (or has been set for production) and will be a qualified film or television production; and

(H) For any pre-amendment production, a declaration that the owner reasonably expects (based on all of the facts and circumstances at the time the election is made) that the aggregate production costs paid or incurred for the pre-amendment production will not, at any time, exceed the applicable aggregate production costs limit set forth under §1.181–1(b)(1)(i) or (b)(2).

(ii) *Subsequent taxable years.* If the owner pays or incurs additional production costs in any taxable year subsequent to the taxable year for which production costs are first deducted under section 181, the owner must attach a statement to its Federal income tax return for that subsequent taxable year providing—

(A) The name (or other unique identifying designation) of the production that was used in the initial election, and any revised name (or unique identifying designation) subsequently used for the production;

(B) The date the aggregate production costs were first paid or incurred for the production;

(C) The amount of aggregate production costs paid or incurred for the production during the current taxable year;

(D) The amount of qualified compensation paid or incurred for the production during the current taxable year;

(E) The amount of compensation paid or incurred for the production during the current taxable year, and the aggregate amount of compensation paid or incurred for the production in all prior taxable years;

(F) If the owner expects that the aggregate production costs of the production will be significantly paid or incurred in (or, if applicable, if a significant portion of the total number of days of first-unit principal photography will occur in) one or more of the areas specified in §1.181–1(b)(2)(i), the identity of the area or areas, the amount of aggregate production costs paid or incurred (or the number of days of first-unit principal photography engaged in) for the applicable activities described in §1.181–1(b)(2)(ii), (b)(2)(iii), or (b)(2)(iv), as applicable, that took place within such areas, and the aggregate production costs paid or incurred (or the number of days of first-unit principal photography engaged in) for such activities (whether or not they took place in such areas), for the current taxable year;

(G) A declaration that the owner continues to reasonably expect (based on all of the facts and circumstances at the end of the current taxable year) both that the production will be set for production (or has been set for production) and will be a qualified film or television production; and

(H) For any pre-amendment production, a declaration that the owner continues to reasonably expect (based on all of the facts and circumstances at the end of the current taxable year) that the aggregate production costs paid or incurred for the pre-amendment production will not, at any time, exceed the applicable aggregate production costs limit set forth under §1.181–1(b)(1)(i) or (b)(2).

(3) *Deductions by more than one person.* If more than one person will claim deductions under section 181 with respect to the production for the taxable year, each person claiming the deduction (but not the members of an entity who are issued a Schedule K–1 by the entity with respect to their interest in the production) must provide a list of the names and taxpayer identification numbers of all such persons, the dollar amount that each such person will deduct under section 181, and the information required by paragraph (c)(2) of this section for all such persons. Notwithstanding the preceding sentence, whether or not multiple persons form a partnership with respect to the production will be determined in accordance with §301.7701–3 of this chapter.

(d) *Revocation of election*—(1) *In general.* An owner may revoke an election made under this section only with the consent of the Commissioner. Except as provided in paragraph (d)(2) of this section, an owner seeking consent to revoke an election made under this section must submit a letter ruling request, other than a Form 3115, ''Application for Change in Accounting Method,'' under the appropriate revenue procedure. See, for example, Rev. Proc. 2011–1, 2011–1 CB 1 (updated annually) (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Consent granted.* The Commissioner grants consent to an owner to revoke an election under this section for a particular production if the owner—

(i) Complies with the recapture provisions of § 1.181–4(a)(3) on a timely filed (including any extension) original Federal income tax return for the taxable year of the revocation; and

(ii) Attaches a statement to that Federal income tax return that includes the name of the production that was in the owner's original election statement, and any revised name (or other unique identifying designation) of the production, and a statement that the owner revokes the election under section 181 for that production, pursuant to § 1.181–2(d)(2).

[T.D. 9551, 76 FR 60726, Sept. 30, 2011]

§ 1.181–3 Qualified film or television production.

(a) *In general.* The term *qualified film or television production* means any production (as defined in paragraph (b) of this section) for which not less than 75 percent of the aggregate amount of compensation (as defined in paragraph (c) of this section) paid or incurred for the production is qualified compensation (as defined in paragraph (d) of this section).

(b) *Production*—(1) *In general.* Except as provided in paragraph (b)(3) of this section, for purposes of this section and §§ 1.181–1, 1.181–2, 1.181–4, 1.181–5, and 1.181–6, the term *production* means any motion picture film or video tape (including digital video) production the production costs of which are subject to capitalization under section 263A, or that would be subject to capitalization if section 263A applied to the owner of the production. If, prior to its initial release or broadcast, a person acquires a completed motion picture film or video tape (including digital video) that the seller was entitled to treat as a production under this paragraph (b)(1), then the new owner may treat the acquired asset as a production within the meaning of this paragraph (b)(1).

(2) *Special rules for television productions.* Each episode of a television series is a separate production to which the rules, limits, and election requirements of this section and §§ 1.181–1, 1.181–2, 1.181–4, 1.181–5, and 1.181–6 apply. An owner may elect to deduct production costs under section 181 only for the first 44 episodes of a television series (including pilot episodes). A television series may include more than one season of programming.

(3) *Exception for certain sexually explicit productions.* A production does not include property for which records are required to be maintained under 18 U.S.C. 2257.

(c) *Compensation.* The term *compensation* means, for purposes of this section and § 1.181–2(c)(2), all amounts paid or incurred either directly by the owner or indirectly on the owner's behalf for services performed by actors (as defined in paragraph (f)(1) of this section), directors, producers, and other production personnel (as defined in paragraph (f)(2) of this section) for the production. Examples of indirect payments paid or incurred on the owner's behalf are payments by a partner on behalf of an owner that is a partnership, payments by a shareholder on behalf of an owner that is a corporation, and payments by a contract producer on behalf of the owner. Payments for services are all elements of compensation as provided for in §§ 1.263A–1(e)(2)(i)(B) and (e)(3)(ii)(D). Compensation is not limited to wages reported on Form W–2, ''Wage and Tax Statement,'' and includes compensation paid or incurred to independent contractors. However, solely for purposes of paragraph (a) of this section, the term ''compensation'' does not include participations and residuals (as defined in section 167(g)(7)(B)). See § 1.181–1(a)(3) for additional rules concerning participations and residuals.

(d) *Qualified compensation.* The term *qualified compensation* means, for purposes of this section and § 1.181–2(c)(2), all compensation (as defined in paragraph (c) of this section) paid or incurred for services performed in the United States (as defined in paragraph (f)(3) of this section) by actors, directors, producers, and other production personnel for the production. A service is performed in the United States for purposes of this paragraph (d) if the principal photography to which the compensated service relates occurs within the United States and the person performing the service is physically present in the United States. For purposes of an animated film or animated television production, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances are performed is considered in lieu of the location of principal photography. For purposes of a production incorporating both live action and animation, the location where production activities such as keyframe animation, in-between animation, animation photography, and the recording of voice acting performances for the production is considered in addition to the location of principal photography.

(e) *Special rule for acquired productions.* A person who acquires a production from a prior owner must take into account all compensation paid or incurred by or on behalf of the seller and any previous owners in determining if the production is a qualified film or television production as defined in paragraph (a) of this section. Any owner that elects to deduct as production costs the costs of acquiring a production and any subsequent production costs must obtain from the seller detailed records concerning the compensation paid or incurred for the production and, for a pre-amendment production, concerning aggregate production costs, in order to demonstrate the eligibility of the production under section 181.

(f) *Other definitions.* The following definitions apply for purposes of this section and §§ 1.181–1, 1.181–2, 1.181–4, 1.181–5, and 1.181–6:

(1) *Actors.* The term *actors* means players, newscasters, or any other persons who are compensated for their performance or appearance in a production.

(2) *Production personnel.* The term *production personnel* means persons who are compensated for providing services directly related to the production, such as writers, choreographers, composers, casting agents, camera operators, set designers, lighting technicians, and make-up artists.

(3) *United States.* The term *United States* means the 50 states, the District of Columbia, the territorial waters of the continental United States, the airspace or space over the continental United States and its territorial waters, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the continental United States and over which the United States has exclusive rights, in accordance with international law, for the exploration and exploitation of natural resources. The term ''United States'' does not include possessions and territories of the United States (or the airspace or space over these areas).

[T.D. 9551, 76 FR 60727, Sept. 30, 2011]

§ 1.181–4 Special rules.

(a) *Recapture*—(1) *Applicability*—(i) *In general.* The requirements of this paragraph (a) apply notwithstanding whether an owner has satisfied the revocation requirements of § 1.181–2(d). An owner that claimed a deduction under section 181 for a production in any taxable year in an amount in excess of the amount that would be allowable as a deduction for that year in the absence of section 181 must recapture the excess amount as provided for in paragraph (a)(3) of this section for the production in the first taxable year for which—

(A) For any pre-amendment production, the aggregate production costs of the production exceed the applicable aggregate production costs limit under § 1.181–1(b)(1)(i) or (b)(2);

(B) For any pre-amendment production, the owner no longer reasonably expects (based on all of the facts and circumstances at the end of the current taxable year) that the aggregate production costs of the production will not, at any time, exceed the applicable aggregate production costs limit set forth under § 1.181–1(b)(1)(i) or (b)(2);

(C) The owner no longer reasonably expects (based on all of the facts and circumstances at the end of the current taxable year) either that the production will be set for production or that the production will be a qualified film or television production; or

(D) The owner revokes the election pursuant to §1.181–2(d).

(ii) *Special rule.* An owner that claimed a deduction under section 181 and disposes of the production prior to its initial release or broadcast must recapture the entire amount specified under paragraph (a)(3) of this section in the year the owner disposes of the production before computing gain or loss from the disposition.

(2) *Principal photography not commencing prior to the date of expiration of section 181.* If an owner claims a deduction under section 181 for a production for which principal photography does not commence prior to the date of expiration of section 181, the owner must recapture deductions as provided for in paragraph (a)(3) of this section in the owner's taxable year that includes the date of expiration of section 181.

(3) *Amount of recapture.* An owner subject to the recapture requirements under this section must, for the taxable year in which recapture is required, include in the owner's gross income as ordinary income and add to the owner's adjusted basis in the property—

(i) For a production that is placed in service in a taxable year prior to the taxable year for which recapture is required, the difference between the aggregate amount the owner claimed as a deduction under section 181 for the production for all such prior taxable years and the aggregate depreciation deductions that would have been allowable for the production for such prior taxable years (or that the owner could have elected to deduct in the taxable year that the production was placed in service) for the production under the owner's method of accounting; or

(ii) For a production that has not been placed in service, the aggregate amount claimed as a deduction under section 181 for the production for all such prior taxable years.

(b) *Recapture under section 1245.* For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as a deduction allowable for amortization.

[T.D. 9551, 76 FR 60728, Sept. 30, 2011]

§ 1.181–5 Examples.

The following examples illustrate the application of §§1.181–1 through 1.181–4:

Example 1. X, a corporation that uses an accrual method of accounting and files Federal income tax returns on a calendar-year basis, is a producer of films. X is the owner (within the meaning of §1.181–1(a)(2)) of film ABC. X incurs production costs in year 1, but does not commence principal photography for film ABC until year 2. In year 1, X reasonably expects, based on all of the facts and circumstances, that film ABC will be set for production and will be a qualified film or television production. Provided that X satisfies all other requirements of §§1.181–1 through 1.181–4 and §1.181–6, X may deduct in year 1 the production costs for film ABC that X incurred in year 1.

Example 2. The facts are the same as in *Example 1.* In year 2, X begins, but does not complete, principal photography for film ABC. Most of the scenes that X films in year 2 are shot outside the United States and, as of December 31, year 2, less than 75 percent of the total compensation paid for film ABC is qualified compensation. Nevertheless, X still reasonably expects, based on all of the facts and circumstances, that film ABC will be a qualified film or television production. Provided that X satisfies all other requirements of §§1.181–1 through 1.181–4 and §1.181–6, X may deduct in year 2 the production costs for film ABC that X incurred in year 2.

Example 3. The facts are the same as in *Example 2.* In year 3, X continues, but does not complete, production of film ABC. Due to changes in the expected production costs of film ABC, X no longer expects film ABC to qualify under section 181. X files a statement with its return for year 3 identifying the film and stating that X revokes its election under section 181. X includes in income in year 3 the deductions claimed in year 1 and in year 2 as provided for in §1.181–4(a)(3). X has successfully revoked its election pursuant to §1.181–2(d).

[T.D. 9551, 76 FR 60729, Sept. 30, 2011]

§ 1.181–6 Effective/applicability date.

(a) *In general.* Except as otherwise provided in this section, §§1.181–1 through 1.181–5 apply to productions the first day of principal photography for which occurs on or after September 29, 2011. Paragraphs 1.181–1(a)(1)(ii), (a)(6), (b)(1)(ii), (b)(2)(vi), and (c)(2) of §1.181–1 apply to productions to which section 181 is applicable and for which the first day of principal photography or in-between animation occurs on or after December 7, 2012.

(b) *Pre-effective date productions.* For any taxable year for which the period of limitation on refund or credit under section 6511 has not expired, the owner may apply §§1.181–1 through 1.181–5 to any production to which section 181 applies and for which the first day of principal photography (or in-between animation) occurred before December 7, 2012, provided the owner applies all relevant provisions of §§1.181–1 through 1.181–5 to the production.

[T.D. 9603, 77 FR 72924, Dec. 7, 2012]

§1.182–1 Expenditures by farmers for clearing land; in general.

Under section 182, a taxpayer engaged in the business of farming may elect, in the manner provided in §1.182–6, to deduct certain expenditures paid or incurred by him in any taxable year beginning after December 31, 1962, in the clearing of land. The expenditures to which the election applies are all expenditures paid or incurred during the taxable year in clearing land for the purpose of making the ''land suitable for use in farming'' (as defined in §1.182–4) which are not otherwise deductible (exclusive of expenditures for or in connection with depreciable items referred to in paragraph (b)(1) of §1.182–3), but only if such expenditures are made in furtherance of the taxpayer's business of farming. The term *expenditures* to which the election applies also includes a reasonable allowance for depreciation (not otherwise allowable) on equipment used in the clearing of land provided such equipment, if used in the carrying on of a trade or business, would be subject to the allowance for depreciation under section 167. (See paragraph (c) of §1.182–3.) (See section 175 and the regulations thereunder for deductibility of certain expenditures for treatment or moving of earth by a farmer where the land already qualifies as land used in farming as defined in §1.175–4.) The amount deductible for any taxable year is limited to the lesser of $5,000 or 25 percent of the taxable income derived from farming (as defined in paragraph (a)(2) of §1.182–5) during the taxable year. Expenditures paid or incurred in a taxable year in excess of the amount deductible under section 182 for such taxable year shall be treated as capital expenditures and shall constitute an adjustment to the basis of the land under section 1016(a).

[T.D. 6794, 30 FR 790, Jan. 26, 1965]

§1.182–2 Definition of "the business of farming."

Under section 182, the election to deduct expenditures incurred in the clearing of land is applicable only to a taxpayer who is engaged in ''the business of farming'' during the taxable year. A taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. For purposes of section 182, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming. However, a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm. A taxpayer engaged in forestry or the growing of timber is not thereby engaged in the business of farming. A person cultivating or operating a farm for recreation or pleasure rather than for profit is not engaged in the business of farming. For purposes of section 182 and this section, the term *farm* is used in its ordinary, accepted sense and includes stock, dairy, poultry, fish, fruit, and truck farms, and also plantations, ranches, ranges, and orchards. A fish farm is an area where fish are grown or raised, as opposed to merely caught or harvested; that is, an area where they are artificially fed, protected, cared for, etc. A taxpayer is engaged in ''the business of farming'' if he is a member of a partnership engaged in the business of farming. See §1.702–1.

[T.D. 6794, 30 FR 790, Jan. 26, 1965]

§1.182–3 Definition, exceptions, etc., relating to deductible expenditures.

(a) *Clearing of land.* (1) For purposes of section 182, the term *clearing of land* includes (but is not limited to):

(i) The removal of rocks, stones, trees, stumps, brush or other natural impediments to the use of the land in farming through blasting, cutting, burning, bulldozing, plowing, or in any other way;

(ii) The treatment or moving of earth, including the construction, repair or removal of nondepreciable earthen structures, such as dikes or levies, if the purpose of such treatment or moving of earth is to protect, level, contour, terrace, or condition the land so as to permit its use as farming land; and

(iii) The diversion of streams and watercourses, including the construction of nondepreciable drainage facilities, provided that the purpose is to remove or divert water from the land so as to make it available for use in farming.

(2) The following are examples of land clearing activities:

(i) The cutting of trees, the blasting of the resulting stumps, and the burning of the residual undergrowth;

(ii) The leveling of land so as to permit irrigation or planting;

(iii) The removal of salt or other minerals which might inhibit cultivation of the soil;

(iv) The draining and filling in of a swamp or marsh; and

(v) The diversion of a stream from one watercourse to another.

(b) *Expenditures not allowed as a deduction under section 182.* (1) Section 182 applies only to expenditures for nondepreciable items. Accordingly, a taxpayer may not deduct expenditures for the purchase, construction, installation, or improvement of structures, appliances, or facilities which are of a character which is subject to the allowance for depreciation under section 167 and the regulations thereunder. Expenditures in respect of such depreciable property include those for materials, supplies, wages, fuel, freight, and the moving of earth, paid or incurred with respect to tanks, reservoirs, pipes, conduits, canals, dams, wells, or pumps constructed of masonry, concrete, tile, metal, wood, or other nonearthen material.

(2) Expenditures which are deductible without regard to section 182 are not deductible under section 182. Thus, such expenditures are deductible without being subject to the limitations imposed by section 182(b) and §1.182–5. For example, section 182 does not apply to the ordinary and necessary expenses incurred in the business of farming which are deductible under section 162 even though they might otherwise be considered to be clearing of land expenditures. Section 182 also does not apply to interest (deductible under section 163) nor to taxes (deductible under section 164). Similarly, section 182 does not apply to any expenditures (whether or not currently deductible) paid or incurred for the purpose of soil or water conservation in respect of land used in farming, or for the prevention of erosion of land used in farming, within the meaning of section 175 and the regulations thereunder, nor to expenditures deductible under section 180 and the regulations thereunder, relating to expenditures for fertilizer, etc.

(c) *Depreciation.* In addition to expenditures for the activities described in paragraph (a) of this section, there also shall be treated as an expenditure to which section 182 applies a reasonable allowance for depreciation not otherwise deductible on property of the taxpayer which is used in the clearing of land for the purpose of making such land suitable for use in farming, provided the property is property which, if used in a trade or business, would be subject to the allowance for depreciation under section 167. Depreciation allowable as a deduction under section 182 is limited to the portion of depreciation which is attributable to the use of the property in the clearing of land. The depreciation shall be computed in accordance with section 167 and the regulations thereunder. To the extent an amount representing a reasonable allowance for depreciation with respect to property used in clearing land is treated as an expenditure to which section 182 applies, such depreciation shall, for purposes of chapter 1 of the Code, be treated as an amount allowed under section 167 for depreciation. Thus, if a deduction is allowed for depreciation under section 182 in respect of property used in clearing land, proper adjustment to the basis of the property so used shall be made under section 1016(a).

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.182–4 Definition of "land suitable for use in farming", etc.

For purposes of section 182, the term *land suitable for use in farming* means land which, as a result of the land clearing activities described in paragraph (a) of § 1.182–3, could be used by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products, including fish, or for the sustenance of livestock. The term *livestock* includes cattle, hogs, horses, mules, donkeys, sheep, goats, captive fur-bearing animals, chickens, turkeys, pigeons, and other poultry. Land used for the sustenance of livestock includes land used for grazing such livestock. Expenditures are considered to be for the purpose of making land suitable for use in farming by the taxpayer or his tenant only if made to prepare the land which is cleared for use by the taxpayer or his tenant in farming. Thus, if the taxpayer pays or incurs expenditures to clear land for the purpose of sale (whether or not for use in farming by the purchaser) or to be held by the taxpayer or his tenant other than for use in farming, section 182 does not apply to such expenditures. Whether the land is cleared for the purpose of making it suitable for use in farming by the taxpayer or his tenant, is a question of fact which must be resolved on the basis of all the relevant facts and circumstances. For purposes of section 182, it is not necessary that the land cleared actually be used in farming following the clearing activities. However, the fact that following the clearing operation, the land is used by the taxpayer or his tenant in the business of farming will, in most cases, constitute evidence that the purpose of the clearing was to make land suitable for use in farming by the taxpayer or his tenant. On the other hand, if the land cleared is sold or converted to nonfarming use soon after the taxpayer has completed his clearing activities, there will be a presumption that the expenditures were not made for the purpose of making the land suitable for use in farming by the taxpayer or his tenant. Other factors which will be considered in determining the taxpayer's purpose for clearing the land are, for example, the acreage, location, and character of the land cleared, the nature of the taxpayer's farming operation, and the use to which adjoining or nearby land is put.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.182–5 Limitation.

(a) *Limitation*—(1) *General rule.* The amount of land clearing expenditures which the taxpayer may deduct under section 182 in any one taxable year is limited to the lesser of $5,000 or 25 percent of his ''taxable income derived from farming''. Expenditures in excess of the applicable limitation are to be charged to the capital account and constitute additions to the taxpayer's basis in the land.

(2) *Definition of ''taxable income derived from farming''.* For purposes of section 182, the term *taxable income derived from farming* means the gross income derived from the business of farming reduced by the deductions attributable to such gross income. Gross income derived from the business of farming is the gross income of the taxpayer derived from the production of crops, fruits, or other agricultural products, including fish, or from livestock (including livestock held for draft, breeding or dairy purposes). It does not include gains from sales of assets such as farm machinery or gains from the disposition of land. The deductions attributable to the business of farming are all the deductions allowed by Chapter 1 of the Code (other than the deduction allowed by section 182) for expenditures or charges (including depreciation and amortization) paid or incurred in connection with the production or raising of crops, fruits, or other agricultural products, including fish, or livestock. However, the deduction under section 1202 (relating to the capital gains deduction) attributable to gain on the sale or other disposition of assets (other than draft, breeding, or dairy stock), and the net operating loss deduction (computed under section 172) shall not be taken into account in computing ''taxable income derived from farming.'' Similarly, deductible losses on the sale, disposition, destruction, condemnation, or abandonment of assets (other than draft, breeding, or dairy stock) shall not be considered as deductions attributable to the business of farming. A taxpayer shall compute

his gross income from farming in accordance with his accounting method used in determining gross income. (See the regulations under section 61 relating to accounting methods used by farmers in determining gross income.)

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

Example 1. For the taxable year 1963, A, who uses the cash receipts and disbursements method of accounting, incurs expenditures to which section 182 applies in the amount of $2,000 and makes the election under section 182. A has the following items of income and deductions (without regard to section 182 expenditures).

Income:		
Proceeds from sale of his 1963 yield of corn	$10,000	
Proceeds from sales of milk	8,000	
Gain from disposition of old breeding cows	500	
Gain from sale of tractor	100	
Gain from sale of farmland	5,000	
Interest on loan to brother	100	
	23,700	
Deductions:		
Cost of labor	4,000	
Cost of feed	3,000	
Depreciation on farm equipment and buildings	2,500	
Cost of maintenance, fuel, etc	2,000	
Interest paid, mortgage on farm buildings	1,000	
Interest paid, personal loan	500	
Loss on destruction of barn	2,000	
Loss on sale of truck	300	
Section 1202 deduction—gain on sale of cows (500 × 1/2)	250	
Section 1202 deduction—net gain on disposition of section 1231 property, other than cows [$2,800 ($5,100 − $2,300) × ½]	1,400	
		$16,950
Net income before section 182 deduction		6,750

For purposes of computing taxable income derived from farming under section 182, the following items of income and deductions are not taken into account:

Income:		
Gain from the sale of tractor	$100	
Gain from the sale of farmland	5,000	
Interest on loan to brother	100	
		$5,200
Deductions:		
Interest paid, personal loan	$500	
Loss on destruction of barn	2,000	
Loss on sale of truck	300	
Section 1202 deduction—Net gain from disposition of 1231 assets other than cows	1,400	
		$4,200

A's ''taxable income derived from farming'' for purposes of section 182 is $5,750; income of $18,500 ($23,700 − $5,200), less deductions of $12,750 ($16,950 − $4,200). A may deduct $1,437.50 (25% of $5,750) under section 182. The excess expenditures in the amount of $562.50 are to be charged to capital account and serve to increase the taxpayer's basis of the land.

Example 2. Assume the same facts as in *Example 1* and in addition, assume that A is allowed a deduction for a net operating loss carryback from the taxable year 1966 in the amount of $3,000. The net operating loss deduction will not be taken into account in computing A's ''taxable income derived from farming'' for 1963 Accordingly, A will not be required to recompute such taxable income for purposes of applying the limitation on the deduction provided in section 182 and the deduction of $1,437.50 will not be reduced.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.182–6 Election to deduct land clearing expenditures.

(a) *Manner of making election*. The election to deduct expenditures for land clearing provided by section 182(a) shall be made by means of a statement attached to the taxpayer's income tax return for the taxable year for which such election is to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the time prescribed by law for filing the income tax return (including extensions thereof) for the taxable year for which the election is to apply. The statement shall also set forth the amount and description of the expenditures for land clearing claimed as a deduction under section 182, and shall include a computation of ''taxable income derived from farming'', if the amount of such income is not the same as the net income from farming shown on Schedule F of Form 1040, increased by the amount of the deduction claimed under section 182.

(b) *Scope of election*. An election under section 182(a) shall apply only to the taxable year for which made. However, once made, an election applies to all expenditures described in §1.182–3 paid or incurred during the taxable year, and is binding for such taxable year unless the district director consents to a revocation of such election. Requests for consent to revoke an election under section 182 shall be made by means of a letter to the district director for the district in which the taxpayer is required to file his return, setting forth the taxpayer's name, address and identification number, the year for which it is desired to revoke the election, and the reasons therefor. However, consent will not be granted where the only reason therefor is a change in tax consequences.

[T.D. 6794, 30 FR 791, Jan. 26, 1965]

§ 1.183–1 Activities not engaged in for profit.

(a) *In general.* Section 183 provides rules relating to the allowance of deductions in the case of activities (whether active or passive in character) not engaged in for profit by individuals and electing small business corporations, creates a presumption that an activity is engaged in for profit if certain requirements are met, and permits the taxpayer to elect to postpone determination of whether such presumption applies until he has engaged in the activity for at least 5 taxable years, or, in certain cases, 7 taxable years. Whether an activity is engaged in for profit is determined under section 162 and section 212 (1) and (2) except insofar as section 183(d) creates a presumption that the activity is engaged in for profit. If deductions are not allowable under sections 162 and 212 (1) and (2), the deduction allowance rules of section 183(b) and this section apply. Pursuant to section 641(b), the taxable income of an estate or trust is computed in the same manner as in the case of an individual, with certain exceptions not here relevant. Accordingly, where an estate or trust engages in an activity or activities which are not for profit, the rules of section 183 and this section apply in computing the allowable deductions of such trust or estate. No inference is to be drawn from the provisions of section 183 and the regulations thereunder that any activity of a corporation (other than an electing small business corporation) is or is not a business or engaged in for profit. For rules relating to the deductions that may be taken into account by taxable membership organizations which are operated primarily to furnish services, facilities, or goods to members, see section 277 and the regulations thereunder. For the definition of an activity not engaged in for profit, see § 1.183–2. For rules relating to the election contained in section 183(e), see § 1.183–3.

(b) *Deductions allowable*—(1) *Manner and extent.* If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:

(i) Amounts allowable as deductions during the taxable year under Chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).

(ii) Amounts otherwise allowable as deductions during the taxable year under Chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under Chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

(2) *Rule for deductions involving basis adjustments*—(i) *In general.* If deductions are allowed under subparagraph

(1)(iii) of this paragraph, and such deductions are allowed with respect to more than one asset, the deduction allowed with respect to each asset shall be determined separately in accordance with the computation set forth in subdivision (ii) of this subparagraph.

(ii) *Basis adjustment fraction.* The deduction allowed under subparagraph (1)(iii) of this paragraph is computed by multiplying the amount which would have been allowed, had the activity been engaged in for profit, as a deduction with respect to each particular asset which involves a basis adjustment, by the basis adjustment fraction:

(*a*) The numerator of which is the total of deductions allowable under subparagraph (1)(iii) of this paragraph, and

(*b*) The denominator of which is the total of deductions which involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit.

The amount resulting from this computation is the deduction allowed under subparagraph (1)(iii) of this paragraph with respect to the particular asset. The basis of such asset is adjusted only to the extent of such deduction.

(3) *Examples.* The provisions of subparagraphs (1) and (2) of this paragraph may be illustrated by the following examples:

Example 1. A, an individual, maintains a herd of dairy cattle, which is an "activity not engaged in for profit" within the meaning of section 183(c). A sold milk for $1,000 during the year. During the year A paid $300 State taxes on gasoline used to transport the cows, milk, etc., and paid $1,200 for feed for the cows. For the year A also had a casualty loss attributable to this activity of $500. A determines the amount of his allowable deductions under section 183 as follows:

(i) First, A computes his deductions allowable under subparagraph (1)(i) of this paragraph as follows:

State gasoline taxes specifically allowed under section 164(a)(5) without regard to whether the activity is engaged in for profit	$300
Casualty loss specifically allowed under section 165(c)(3) without regard to whether the activity is engaged in for profit ($500 less $100 limitation)	400
Deductions allowable under subparagraph (1)(i) of this paragraph	700

(ii) Second, A computes his deductions allowable under subparagraph (1)(ii) of this paragraph (deductions which would be allowed under chapter 1 of the Code if the activity were engaged in for profit and which do not involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph:

Income from milk sales	$1,000
Gross income from activity	1,000
Less: deductions allowable under subparagraph (1)(i) of this paragraph	700
Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph	300
Feed for cows	1,200
Deduction allowed under subparagraph (1)(ii) of this paragraph	300

$900 of the feed expense is not allowed as a deduction under section 183 because the total feed expense ($1,200) exceeds the maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph ($300). In view of these circumstances, it is not necessary to determine deductions allowable under subparagraph (1)(iii) of this paragraph which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which involve basis adjustment (the $100 of casualty loss not allowable under subparagraph (1)(i) of this paragraph because of the limitation in section 165(c)(3)) because none of such amount will be allowed as a deduction under section 183.

Example 2. Assume the same facts as in *Example 1*, except that A also had income from sales of hay grown on the farm of $1,200 and that depreciation of $750 with respect to a barn, and $650 with respect to a tractor would have been allowed with respect to the activity had it been engaged in for profit. A determines the amount of his allowable deductions under section 183 as follows:

(i) First, A computes his deductions allowable under subparagraph (1)(i) of this paragraph as follows:

State gasoline taxes specifically allowed under section 164(a)(5) without regard to whether the activity is engaged in for profit	$300
Casualty loss specifically allowed under section 165(c)(3) without regard to whether the activity is engaged in for profit ($500 less $100 limitation)	400
Deductions allowable under subparagraph (1)(i) of this paragraph	700

(ii) Second, A computes his deductions allowable under subparagraph (1)(ii) of this paragraph (deductions which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which do not involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph:

Income from milk sales	$1,000
Income from hay sales	1,200
Gross income from activity	2,200

Less: deductions allowable under subparagraph (1)(i) of this paragraph	700
Maximum amount of deductions allowable under subparagraph (1)(ii) of this paragraph	1,500
Feed for cows	1,200

The entire $1,200 of expenses relating to feed for cows is allowable as a deduction under subparagraph (1)(ii) of this paragraph, since it does not exceed the maximum amount of deductions allowable under such subparagraph.

(iii) Last, A computes the deductions allowable under subparagraph (1)(iii) of this paragraph (deductions which would be allowable under chapter 1 of the Code if the activity were engaged in for profit and which involve basis adjustments) as follows:

Maximum amount of deductions allowable under subparagraph (1)(iii) of this paragraph:

Gross income from farming		$2,200
Less: Deductions allowed under subparagraph (1)(i) of this paragraph	$700	
Deductions allowed under subparagraph (1)(ii) of this paragraph	1,200	1,900
Maximum amount of deductions allowable under subparagraph (1)(iii) of this paragraph		300

(iv) Since the total of A's deductions under chapter 1 of the Code (determined as if the activity was engaged in for profit) which involve basis adjustments ($750 with respect to barn, $650 with respect to tractor, and $100 with respect to limitation on casualty loss) exceeds the maximum amount of the deductions allowable under subparagraph (1)(iii) of this paragraph ($300), A computes his allowable deductions with respect to such assets as follows:

A first computes his basis adjustment fraction under subparagraph (2)(ii) of this paragraph as follows:

The numerator of the fraction is the maximum of deductions allowable under subparagraph (1)(iii) of this paragraph which involve basis adjustments	$300
The denominator of the fraction is the total of deductions that involve basis adjustments which would have been allowed with respect to the activity had the activity been engaged in for profit	1,500

The basis adjustment fraction is then applied to the amount of each deduction which would have been allowable if the activity were engaged in for profit and which involves a basis adjustment as follows:

Depreciation allowed with respect to barn (300/1,500 × $750)	$150
Depreciation allowed with respect to tractor (300/1,500 × $650)	130
Deduction allowed with respect to limitation on casualty loss (300/1,500 × $100)	20

The basis of the barn and of the tractor are adjusted only by the amount of depreciation actually allowed under section 183 with respect to each (as determined by the above computation). The basis of the asset with regard to which the casualty loss was suffered is adjusted only to the extent of the amount of the casualty loss actually allowed as a deduction under subparagraph (1) (i) and (iii) of this paragraph.

(4) *Rule for capital gains and losses*—(i) *In general*. For purposes of section 183 and the regulations thereunder, the gross income from any activity not engaged in for profit includes the total of all capital gains attributable to such activity determined without regard to the section 1202 deduction. Amounts attributable to an activity not engaged in for profit which would be allowable as a deduction under section 1202, without regard to section 183, shall be allowable as a deduction under section 183(b)(1) in accordance with the rules stated in this subparagraph.

(ii) *Cases where deduction not allowed under section 183*. No deduction is allowable under section 183(b)(1) with respect to capital gains attributable to an activity not engaged in for profit if:

(*a*) Without regard to section 183 and the regulations thereunder, there is no excess of net long-term capital gain over net short-term capital loss for the year, or

(*b*) There is no excess of net long-term capital gain attributable to the activity over net short-term capital loss attributable to the activity.

(iii) *Allocation of deduction*. If there is:

(*a*) An excess of net long-term capital gain over net short-term capital loss attributable to an activity not engaged in for profit, and

(*b*) Such an excess attributable to all activities, determined without regard to section 183 and the regulations thereunder, the deduction allowable under section 183(b)(1) attributable to capital gains with respect to each activity not engaged in for profit (with respect to which there is an excess of net long-term capital gain over net short-term capital loss for the year) shall be an amount equal to the deduction allowable under section 1202 for the taxable year (determined without regard to section 183) multiplied by a fraction the numerator of which is the excess of the net long-term capital gain attributable to the activity over the net short-term capital loss attributable to the activity and the denominator of which is an amount equal to the total excess of net long-term capital gain over net short-term capital loss for all activities with respect to which there is such excess. The amount of the total section 1202 deduction allowable for the year shall be reduced by the amount determined to be allocable to activities not engaged in for profit and accordingly allowed as a deduction under section 183(b)(1).

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

Example. A, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as the taxable year, has three activities not engaged in for profit. For his taxable year ending on December 31, 1973, A has a $200 net long-term capital gain from activity No. 1, a $100 net short-term capital loss from activity No. 2, and a $300 net long-term capital gain from activity No. 3. In addition, A has a $500 net long-term capital gain from another activity which he engages in for profit. A computes his deductions for capital gains for calendar year 1973 as follows:

Section 1202 deduction without regard to section 183 is determined as follows:

Net long-term capital gain from activity No. 1	$200
Net long-term capital gain from activity No. 3	300
Net long-term capital gain from activity engaged in for profit	500
Total net long-term capital gain from all activities	1,000
Less: Net short-term capital loss attributable to activity No. 2	100
Aggregate net long-term capital gain over net short-term capital loss from all activities	900
Section 1202 deduction determined without regard to section 183 (one-half of $900)	$450

Allocation of the total section 1202 deduction among A's various activities:

Portion allocable to activity No. 1 which is deductible under section 183(b)(1) (Excess net long-term capital gain attributable to activity No. 1 ($200) over total excess net long-term capital gain attributable to all of A's activities with respect to which there is such an excess ($1,000) times amount of section 1202 deduction ($450))	90
Portion allocable to activity No. 3 which is deductible under section 183(b)(1) (Excess net long-term capital gain attributable to activity No. 3 ($300) over total excess net long-term capital gain attributable to all of A's activities with respect to which there is such an excess ($1,000) times amount of section 1202 deduction ($450))	135
Portion allocable to all activities engaged in for profit (total section 1202 deduction ($450) less section 1202 deduction allowable to activities Nos. 1 and 3 ($225))	225
Total section 1202 deduction deductible under sections 1202 and 183(b)(1)	450

(c) *Presumption that activity is engaged in for profit*—(1) *In general.* If for:

(i) Any 2 of 7 consecutive taxable years, in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, or

(ii) Any 2 of 5 consecutive taxable years, in the case of any other activity, the gross income derived from an activity exceeds the deductions attributable to such activity which would be allowed or allowable if the activity were engaged in for profit, such activity is presumed, unless the Commissioner establishes to the contrary, to be engaged in for profit. For purposes of this determination the deduction permitted by section 1202 shall not be taken into account. Such presumption applies with respect to the second profit year and all years subsequent to the second profit year within the 5- or 7-year period beginning with the first profit year. This presumption arises only if the activity is substantially the same activity for each of the relevant taxable years, including the taxable year in question. If the taxpayer does not meet the requirements of section 183(d) and this paragraph, no inference that the activity is not engaged in for profit shall arise by reason of the provisions of section 183. For purposes of this paragraph, a net operating loss deduction is not taken into account as a deduction. For purposes of this subparagraph a short taxable year constitutes a taxable year.

(2) *Examples.* The provisions of subparagraph (1) of this paragraph may be illustrated by the following examples, in each of which it is assumed that the taxpayer has not elected, in accordance with section 183(e), to postpone determination of whether the presumption described in section 183(d) and this paragraph is applicable.

Example 1. For taxable years 1970–74, A, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as the taxable year, is engaged in the activity of farming. In taxable years 1971, 1973, and 1974, A's deductible expenditures with respect to such activity exceed his gross income from the activity. In taxable years 1970 and 1972 A has income from the sale of farm produce of $30,000 for each year. In each of such years A had expenses for feed for his livestock of $10,000, depreciation of equipment of $10,000, and fertilizer cost of $5,000 which he elects to take as a deduction. A also has a net operating loss carryover to taxable year 1970 of $6,000. A is presumed, for taxable years 1972, 1973, and 1974, to have engaged in the activity of farming for profit, since for 2 years of a 5-consecutive-year period the gross income from the activity ($30,000 for each year) exceeded the deductions (computed without regard to the net operating loss) which are allowable in the case of the activity ($25,000 for each year).

Example 2. For the taxable years 1970 and 1971, B, an individual who uses the cash receipts and disbursement method of accounting and the calendar year as taxable year, engaged in raising pure-bred Charolais cattle for breeding purposes. The operation showed a loss during 1970. At the end of 1971, B sold a substantial portion of his herd and the cattle operation showed a profit for that year. For all subsequent relevant taxable years B continued to keep a few Charolais bulls at stud. In 1972, B started to raise Tennessee Walking Horses for breeding and show purposes, utilizing substantially the same pasture land, barns, and (with structural modifications) the same stalls. The Walking Horse operations showed a small profit in 1973 and losses in 1972 and 1974 through 1976.

(i) Assuming that under paragraph (d)(1) of this section the raising of cattle and raising of horses are determined to be separate activities, no presumption that the Walking Horse operation was carried on for profit arises under section 183(d) and this paragraph since this activity was not the same activity that generated the profit in 1971 and there are not, therefore, 2 profit years attributable to the horse activity.

(ii) Assuming the same facts as in (i) above, if there were no stud fees received in 1972 with respect to Charolais bulls, but for 1973 stud fees with respect to such bulls exceed deductions attributable to maintenance of the bulls in that year, the presumption will arise under section 183(d) and this paragraph with respect to the activity of raising and maintaining Charolais cattle for 1973 and for all subsequent years within the 5-year period beginning with taxable year 1971, since the activity of raising and maintaining Charolais cattle is the same activity in 1971 and in 1973, although carried on by B on a much reduced basis and in a different manner. Since it has been assumed that the horse and cattle operations are separate activities, no presumption will arise with respect to the Walking Horse operation because there are not 2 profit years attributable to such horse operation during the period in question.

(iii) Assuming, alternatively, that the raising of cattle and raising of horses would be considered a single activity under paragraph (d)(1) of this section, B would receive the benefit of the presumption beginning in 1973 with respect to both the cattle and horses since there were profits in 1971 and 1973. The presumption would be effective through 1977 (and longer if there is an excess of income over deductions in this activity in 1974, 1975, 1976, or 1977 which would extend the presumption) if, under section 183(d) and subparagraph (3) of this paragraph, it was determined that the activity consists in major part of the breeding, training, showing, or racing of horses. Otherwise, the presumption would be effective only through 1975 (assuming no excess of income over deductions in this activity in 1974 or 1975 which would extend the presumption).

(3) *Activity which consists in major part of the breeding, training, showing, or racing of horses.* For purposes of this paragraph an activity consists in major part of the breeding, training, showing, or racing of horses for the taxable year if the average of the portion of expenditures attributable to breeding, training, showing, and racing of horses for the 3 taxable years preceding the taxable year (or, in the case of an activity which has not been conducted by the taxpayer for 3 years, for so long as it has been carried on by him) was at least 50 percent of the total expenditures attributable to the activity for such prior taxable years.

(4) *Transitional rule.* In applying the presumption described in section 183(d) and this paragraph, only taxable years beginning after December 31, 1969, shall be taken into account. Accordingly, in the case of an activity referred to in subparagraph (1) (i) or (ii) of this paragraph, section 183(d) does not apply prior to the second profitable taxable year beginning after December 31, 1969, since taxable years prior to such date are not taken into account.

(5) *Cross reference.* For rules relating to section 183(e) which permits a taxpayer to elect to postpone determination of whether any activity shall be presumed to be "an activity engaged in for profit" by operation of the presumption described in section 183(d) and this paragraph until after the close

of the fourth taxable year (sixth taxable year, in the case of activity which consists in major part of breeding, training, showing, or racing of horses) following the taxable year in which the taxpayer first engages in the activity, see §1.183–3.

(d) *Activity defined*—(1) *Ascertainment of activity.* In order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity. In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183. Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

(2) *Rules for allocation of expenses.* If the taxpayer is engaged in more than one activity, an item of deduction or income may be allocated between two or more of these activities. Where property is used in several activities, and one or more of such activities is determined not to be engaged in for profit, deductions relating to such property must be allocated between the various activities on a reasonable and consistently applied basis.

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

Example. (i) A, an individual, owns a small house located near the beach in a resort community. Visitors come to the area for recreational purposes during only 3 months of the year. During the remaining 9 months of the year houses such as A's are not rented. Customarily, A arranges that the house will be leased for 2 months of 3-month recreational season to vacationers and reserves the house for his own vacation during the remaining month of the recreational season. In 1971, A leases the house for 2 months for $1,000 per month and actually uses the house for his own vacation during the other month of the recreational season. For 1971, the expenses attributable to the house are $1,200 interest, $600 real estate taxes, $600 maintenance, $300 utilities, and $1,200 which would have been allowed as depreciation had the activity been engaged in for profit. Under these facts and circumstances, A is engaged in a single activity, holding the beach house primarily for personal purposes, which is an "activity not engaged in for profit" within the meaning of section 183(c). See paragraph (b)(9) of §1.183–2.

(ii) Since the $1,200 of interest and the $600 of real estate taxes are specifically allowable as deductions under sections 163 and 164(a) without regard to whether the beach house activity is engaged in for profit, no allocation of these expenses between the uses of the beach house is necessary. However, since section 262 specifically disallows personal, living, and family expenses as deductions, the maintenance and utilities expenses and the depreciation from the activity must be allocated between the rental use and the personal use of the beach house. Under the particular facts and circumstances, ⅔ (2 months of rental use over 3 months of total use) of each of these expenses are allocated to the rental use, and ⅓ (1 month of personal use over 3 months of total use) of each of these expenses are allocated to the personal use as follows:

	Rental use 2/3—expenses allocable to section 183(b)(2)	Personal use 1/3—expenses allocable to section 262
Maintenance expense $600 ..	$400	$200
Utilities expense $300	200	100
Depreciation $1,200	800	400
Total	1,400	700

The $700 of expenses and depreciation allocated to the personal use of the beach house are disallowed as a deduction under section 262. In addition, the allowability of each of the expenses and the depreciation allocated to section 183(b)(2) is determined under paragraph (b)(1) (ii) and (iii) of this section. Thus, the maximum amount allowable as a deduction under section 183(b)(2) is $200 ($2,000 gross income from activity, less $1,800 deductions under section 183(b)(1)). Since the amounts described in section 183(b)(2) ($1,400) exceed the maximum amount allowable ($200), and since the amounts described in paragraph (b)(1)(ii) of this section ($600) exceed such maximum amount allowable ($200), none of the depreciation (an amount described in paragraph (b)(1)(iii) of this section) is allowable as a deduction.

(e) *Gross income from activity not engaged in for profit defined.* For purposes of section 183 and the regulations thereunder, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

(f) *Rule for electing small business corporations.* Section 183 and this section shall be applied at the corporate level in determining the allowable deductions of an electing small business corporation.

[T.D. 7198, 37 FR 13680, July 13, 1972]

§ 1.183–2 Activity not engaged in for profit defined.

(a) *In general.* For purposes of section 183 and the regulations thereunder, the term *activity not engaged in for profit* means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and § 1.183–1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures is in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

(b) *Relevant factors.* In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(1) *Manner in which the taxpayer carries on the activity.* The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* The term *profit* encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183–1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in

which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

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

Example 1. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.

Example 2. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amounts of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example 3. The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the ''prestige'' tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example 4. The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately $8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area, are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example 5. A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The chances, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his soil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example 6. C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to ''market'' his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

[T.D. 7198, 37 FR 13683, July 13, 1972]

§ 1.183–3 Election to postpone determination with respect to the presumption described in section 183(d). [Reserved]

§ 1.183–4 Taxable years affected.

The provisions of section 183 and the regulations thereunder shall apply only with respect to taxable years beginning after December 31, 1969. For provisions applicable to prior taxable years, see section 270 and § 1.270–1.

[T.D. 7198, 37 FR 13685, July 13, 1972]

§ 1.186–1 Recoveries of damages for antitrust violations, etc.

(a) *Allowance of deduction.* Under section 186, when a compensatory amount which is included in gross income is received or accrued during a taxable year for a compensable injury, a deduction is allowed in an amount equal to the lesser of (1) such compensatory amount, or (2) the unrecovered losses sustained as a result of such compensable injury.

(b) *Compensable injury*—(1) *In general.* For purposes of this section, the term *compensable injury* means any of the injuries described in subparagraph (2), (3), or (4) of this paragraph.

(2) *Patent infringement.* An injury sustained as a result of an infringement of a patent issued by the United States (whether or not issued to the taxpayer or another person or persons) constitutes a compensable injury. The term *patent issued by the United States* means any patent issued or granted by the United States under the authority of the Commissioner of Patents pursuant to 35 U.S.C. 153.

(3) *Breach of contract or of fiduciary duty or relationship.* An injury sustained as a result of a breach of contract (including an injury sustained by a third party beneficiary) or a breach of fiduciary duty or relationship constitutes a compensable injury.

(4) *Injury suffered under certain antitrust law violations.* An injury sustained in business, or to property, by reason of any conduct forbidden in the antitrust laws for which a civil action may be brought under section 4 of the Act of October 15, 1914 (15 U.S.C. 15), commonly known as the Clayton Act, constitutes a compensable injury.

(c) *Compensatory amount*—(1) *In general.* For purposes of this section, the term, *compensatory amount* means any amount received or accrued during the taxable year as damages as a result of an award in, or in settlement of, a civil action for recovery for a compensable injury, reduced by any amounts paid or incurred in the taxable year in securing such award or settlement. The term *compensatory amount* includes only amounts compensating for actual economic injury. Thus, additional amounts representing punitive, exemplary, or treble damages are not included within the term. Where, for example, a taxpayer recovers treble damages under section 4 of the Clayton Act, only one-third of the recovery representing economic injury constitutes a compensatory amount. In the absence of any indication to the contrary, amounts received in settlement of an action shall be deemed to be a recovery for an actual economic injury except to the extent such settlement amounts exceed actual damages claimed by the taxpayer in such action.

(2) *Interest on a compensatory amount.* Interest attributable to a compensatory amount shall not be included within the term *compensatory amount.*

(3) *Settlement of a civil action for damages*—(i) *Necessity for an action.* The term *compensatory amount* does not include an amount received or accrued in settlement of a claim for a compensable injury if the amount is received or accrued prior to institution of an action. An action shall be considered as instituted upon completion of service of process, in accordance with the laws and rules of the court in which the action has been commenced or to which the action has been removed, upon all defendants who pay or incur an obligation to pay a compensatory amount.

(ii) *Specifications of the parties.* If an action for a compensable injury is settled, the specifications of the parties will generally determine compensatory amounts unless such specifications are not reasonably supported by the facts and circumstances of the case. For example, the parties may provide that the sum of $1,000 represents actual damages sustained as the result of antitrust violations and that the total amount of the settlement after the trebling of damages is $3,000. In such case, only the sum of $1,000 would be a compensatory amount. In the absence of specifications of the parties, the complaint filed by the taxpayer may be considered in determining what portion of the amount of the settlement is a compensatory amount.

(4) *Amounts paid or incurred in securing the award or settlement.* For purposes of this section, the term *amounts paid or incurred in the taxable year in securing such award or settlement* shall include legal expenses such as attorney's fees, witness fees, accountant fees, and court costs. Expenses incurred in securing a recovery of both a compensatory amount and other amounts from the same action shall be allocated among such amounts in the ratio each of such amounts bears to the total recovery. For instance, where a taxpayer

incurs attorney's fees and other expenses of $3,000 in recovering $10,000 as a compensatory amount, $5,000 as a return of capital, and $25,000 as punitive damages from the same action, the taxpayer shall allocate $750 of the expenses to the compensatory amount ($10,000/40,000 \times 3,000$), $375 to the return of capital ($5,000/40,000 \times 3,000$), and $1,875 to the punitive damages ($25,000/40,000 \times 3,000$).

(d) *Unrecovered losses*—(1) *In general.* For purposes of this section, the term *unrecovered losses sustained as a result of such compensable injury* means the sum of the amounts of the net operating losses for each taxable year in whole or in part within the injury period, to the extent that such net operating losses are attributable to such compensable injury, reduced by (i) the sum of any amounts of such net operating losses which were allowed as a net operating loss carryback or carryover for any prior taxable year under the provisions of section 172, and (ii) the sum of any amounts allowed as deductions under section 186 (a) and this section for all prior taxable years with respect to the same compensable injury. Accordingly, a deduction is permitted under section 186(a) and this section with respect to net operating losses whether or not the period for carryover under section 172 has expired.

(2) *Injury period.* For purposes of this section, the term *injury period* means (i) with respect to an infringement of a patent, the period during which the infringement of the patent continued, (ii) with respect to a breach of contract or breach of fiduciary duty or relationship, the period during which amounts would have been received or accrued but for such breach of contract or breach of fiduciary duty or relationship, or (iii) with respect to injuries sustained by reason of a violation of section 4 of the Clayton Act, the period during which such injuries were sustained. The injury period will be determined on the basis of the facts and circumstances of the taxpayer's situation. The injury period may include a periods before and after the period covered by the civil action instituted.

(3) *Net operating losses attributable to compensable injuries.* A net operating loss for any taxable year shall be treated as attributable (whether actually attributable or not) to a compensable injury to the extent the compensable injury is sustained during the taxable year. For purposes of determining the extent of the compensable injury sustained during a taxable year, a judgment for a compensable injury apportioning the amount of the recovery (not reduced by any amounts paid or incurred in securing such recovery) to specific taxable years within the injury period will be conclusive. If a judgment for a compensable injury does not apportion the amount of the recovery to specific taxable years within the injury period, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bear to the total net operating losses sustained for all such years. If an action is settled, the specifications of the parties will generally determine the apportionment of the amount of the recovery unless such specifications are not reasonably supported by the facts and circumstances of the case. In the absence of specifications of the parties, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bears to the total net operating losses sustained for all such years.

(4) *Application of losses attributable to a compensable injury.* If only a portion of a net operating loss for any taxable year is attributable to a compensable injury, such portion shall (in applying section 172 for purposes of this section) be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss. If, for example, in the year of the compensable injury the net operating loss was $1,000 and the amount of the compensable injury was $600, the amount of $400 not attributable to the compensable injury would be used first to offset profits in the carryover or carryback periods as prescribed by section 172. After the amount not attributable to the compensable injury is used to offset profits in other years, then the amount attributable to the compensable injury will

be applied against profits in the carryover or carryback periods.

(e) *Effect on net operating loss carryovers*—(1) *In general.* Under section 186 (e) if for the taxable year in which a compensatory amount is received or accrued any portion of the net operating loss carryovers to such year is attributable to the compensable injury for which such amount is received or accrued, such portion of the net operating loss carryovers must be reduced by the excess, if any, of (i) the amount computed under section 186(e)(1) with respect to such compensatory amount, over (ii) the amount computed under section 186(e)(2) with respect to such compensable injury.

(2) *Amount computed under section 186(e)(1).* The amount computed under section 186(e)(1) is equal to the deduction allowed under section 186(a) with respect to the compensatory amount received or accrued for the taxable year.

(3) *Amount computed under section 186(e)(2).* The amount computed under section 186(e)(2) is equal to that portion of the unrecovered losses sustained as a result of the compensable injury with respect to which, as of the beginning of the taxable year, the period for carryover under section 172 has expired without benefit to the taxpayer, but only to the extent that such portion of the unrecovered losses did not reduce an amount computed under section 186(e)(1) for any prior taxable year.

(4) *Increase in income under section 172(b)(2).* If there is a reduction for any taxable year under subparagraph (1) of this paragraph in the portion of the net operating loss carryovers to such year attributable to a compensable injury, then, solely for purposes of determining the amount of such portion which may be carried to subsequent taxable years, the income of such taxable year, as computed under section 172(b)(2), shall be increased by the amount of the reduction computed under subparagraph (1) of this paragraph, for such year.

(f) *Illustration.* The provisions of section 186 and this section may be illustrated by the following example:

Example. (i) As of the beginning of his taxable year 1969, taxpayer A has a net operating loss carryover from his taxable year 1966 of $550 of which $250 is attributable to a compensable injury. In addition, he has a net operating loss attributable to the compensable injury of $150 with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer. In 1969, he receives a $100 compensatory amount with respect to that injury and he has $75 in other income. Thus, A has gross income of $175 and he is entitled to a $100 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the unrecovered losses sustained as a result of the compensable injury ($250 + $150 = $400). No portion of the net operating loss carryover to the current taxable year attributable to the compensable injury is reduced under section 186(e) since the amount determined under section 186(e)(1) ($100) does not exceed the amount determined under section 186(e)(2) ($150). Therefore, A applies a net operating loss carryover of $550 against his remaining income of $75 and retains a net operating loss carryover of $475 to following years of which amount $250 remains attributable to the compensable injury. In addition, he retains $50 of net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(ii) In 1970, A receives a $200 compensatory amount with respect to the same compensable injury and has $75 of other income. Thus, A has gross income of $275 and he is entitled to a $200 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the remaining unrecovered loss sustained as a result of the compensable injury ($250 + $50 = $300). The net operating loss carryover to the current taxable year of $250 attributable to the compensable injury is reduced under section 186(e) by $150, which is the excess of the amount determined under section 186(e)(1) ($200) over the amount determined under section 186(e)(2) ($50). Therefore, A applies net operating loss carryovers of $325 ($225 not attributable to the compensable injury, + $100 attributable to such injury) against his remaining income of $75. A retains net operating loss carryovers of $250 for following years, of which amount $100 is attributable to the compensable injury. A has used all of his net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(iii) In 1971, A receives a $200 compensatory amount with respect to the same compensable injury and has $75 of other income. Thus, A has gross income of $275 and he is entitled to a $100 deduction (the amount of unrecovered losses) under section 186(a) and this section since this amount is less than the compensatory amount received ($200). The net operating loss carryover to the current taxable year of $100 attributable to the compensable injury is reduced under section 186(e) by $100, which is the excess of the amount determined under section 186(e)(1) ($100) over the amount determined under section 186(e)(2) ($0). Therefore, A applies net operating loss carryovers of $150 against his remaining income of $175 ($100 compensatory amount plus $75 other income) which leaves $25 taxable income. No net operating loss carryover remains for following years.

(g) *Effective date.* The provisions of this section are applicable as to compensatory amounts received or accrued in taxable years beginning after December 31, 1968, even though the compensable injury was sustained in taxable years beginning before such date.

[T.D. 7220, 37 FR 24744, Nov. 21, 1972]

§ 1.187–1 Amortization of certain coal mine safety equipment.

(a) *Allowance of deduction*—(1) *In general.* Under section 187(a), every person, at his election, shall be entitled to a deduction with respect to the amortization of the adjusted basis (for determining gain) of any certified coal mine safety equipment (as defined in § 1.187–2), based on a period of 60 months. Such 60-month period shall, at the election of the taxpayer, begin either with the month following the month in which such equipment was placed in service or with the succeeding taxable year. For rules as to making or discontinuing the election, see paragraphs (b) and (c) of this section. For the computation of the adjusted basis (for determining gain) of any certified coal mine safety equipment, see paragraph (b) of § 1.187–2.

(2) *Amount of deduction.* (i) Such amortization deduction shall be an amount, with respect to each month of such 60-month period which falls within the taxable year, equal to the adjusted basis for determining gain of the certified coal mine safety equipment at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in such 60-month period. Such adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to any certified coal mine safety equipment for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year.

(ii) If any certified coal mine safety equipment is sold or exchanged or otherwise disposed of during a particular month, then the amortization deduction (if any) allowable to the transferor in respect of that month shall be that portion of the amount to which such person would be entitled for a full month which the number of days in such month during which the equipment was held by such person bears to the total number of days in such month.

(3) *Effect on other deductions.* (i) The amortization deduction provided by section 187(a) with respect to any month shall be in lieu of the depreciation deduction which would otherwise be allowable with respect to such equipment under section 167 for such month.

(ii) If the adjusted basis of such coal mine safety equipment as computed under section 1011 for purposes other than the amortization deduction provided by section 187(a) is in excess of the adjusted basis, as computed under paragraph (b) of § 1.187–2, then such excess shall be recovered through depreciation deductions under the rules of section 167. See section 187(e), and paragraph (b)(2) of § 1.187–2.

(iii) See section 179 and paragraph (e)(1)(ii) of § 1.179–1 for additional first-year depreciation in respect of certified coal mine safety equipment.

(4) *Special rules.* (i) If the assets of a corporation which has elected to take the amortization deduction under section 187(a) are acquired by another corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the transferor or distributor corporation for purposes of this section.

(ii) For the right of estates and trusts to take the amortization deduction provided by section 187 see section 642(f) and § 1.642(f)-1.

(iii) For the allowance of the amortization deduction in the case of coal mine safety equipment of partnerships see section 703 and § 1.703–1.

(iv) In the case of certified coal mine safety equipment held by one person for life with the remainder to another person, the amortization deduction under section 187(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(5) *Effective date.* The provisions of this paragraph shall apply to taxable years ending after December 31, 1969.

(6) *Meaning of terms.* Except as otherwise provided in § 1.187–2, all terms used in section 187 and the regulations thereunder shall have the meaning provided by this section and § 1.187–2.

(b) *Election of amortization*—(1) *In general.* Under section 187(b), an election by the taxpayer to make amortization deductions with respect to any certified coal mine safety equipment and to begin the 60-month amortization period shall be made by a statement to that effect attached to his return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information:

(i) A description clearly identifying each piece of certified coal mine safety equipment for which an amortization deduction is claimed;

(ii) The date on which such equipment was ''placed in service'' (see paragraph (a)(2)(i) of § 1.187–2);

(iii) The date on which the amortization period began;

(iv) The total costs paid or incurred in the acquisition and installation of such equipment;

(v) A computation showing the adjusted basis (as defined in paragraph (b) of § 1.187–2) of the equipment as of the beginning of the amortization period;

(vi) In the case of electric face equipment which is newly acquired by the taxpayer, a statement that the equipment has been certified by the Secretary of the Interior or the Director of the Bureau of Mines as being permissible within the meaning of section 305(a)(2) of the Federal Coal Mine Health and Safety Act of 1969; and

(vii) In the case of property placed in service in connection with used electric face equipment (within the meaning of paragraph (a)(2)(ii) of § 1.187–2), a statement that such property has resulted in the used electric face equipment becoming permissible and a copy of the notification that such property is permissible.

(2) *Late certification.* If, 90 days before the date on which the return described in this paragraph is due, a piece of coal mine safety equipment has not been certified as permissible by the Secretary of the Interior or the Director of the Bureau of Mines, then the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the equipment is certified as permissible by the Secretary of the Interior or the Director of the Bureau of Mines. Amended income tax returns or claims for credit or refund should also be filed at this time for other taxable years which are within the amortization period and which are subsequent to the taxable year for which the election is made. Nothing in this paragraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *Other requirements and considerations.* No method of making the election provided for in section 187(a) other than that prescribed in this section shall be permitted on or after August 11, 1971. A taxpayer who does not elect in the manner prescribed in this section to take amortization deductions with respect to certified coal mine safety equipment shall not be entitled to such deductions. In the case of a taxpayer who has elected prior to August 11, 1971 the statement required by subparagraph (1) of this paragraph shall be attached to his income tax return for his taxable year in which August 11, 1971 occurs.

(c) *Election to discontinue or revoke amortization*—(1) *Election to discontinue.* (i) Under section 187(c), if a taxpayer has elected to take the amortization deduction provided by section 187(a) with respect to any certified coal mine safety equipment, he may, after such election and prior to the expiration of the 60-month amortization period, elect to discontinue the amortization deduction for the remainder of the 60-month period for such equipment.

(ii) An election to discontinue the amortization deduction shall be made by a statement in writing filed with the District Director or with the director of the Internal Revenue Service center with whom the return of the taxpayer is required to be filed for its taxable year in which falls the first month for which the election terminates. In addition, a copy of such statement shall be attached to the taxpayer's income tax return filed for such taxable year. Such statement shall specify the month as of the beginning of which the taxpayer elects to discontinue such deductions, and shall be filed before the beginning of the month specified therein. In addition, such notice shall contain a description clearly identifying the certified coal mine safety equipment with respect to which the taxpayer elects to discontinue the amortization deduction. If the taxpayer so elects to discontinue the amortization deduction, he shall not be entitled to any further amortization deductions under section 187 with respect to such equipment.

(2) *Revocation of elections made prior to August 11, 1971.* If before August 11, 1971 an election under section 187(a) has been made, consent is hereby given for the taxpayer to revoke such election without the consent of the Commissioner. Such election may be revoked by filing a notice of revocation on or before November 9, 1971. Such notice shall be in the form and shall be filed in the manner required by subparagraph (1)(ii) of this paragraph. If such revocation is for a period which falls within one or more taxable years for which an income tax return has been filed, an amended income tax return shall be filed for any taxable year in which a deduction was taken under section 187 on or before November 9, 1971.

(3) *Depreciation subsequent to discontinuance or in the case of revocation of amortization.* (i) A taxpayer who elects in the manner prescribed under subparagraph (1) of this section to discontinue amortization deductions under section 187(a) or under subparagraph (2) of this paragraph to revoke an election made prior to August 11, 1971 with respect to an item of certified coal mine safety equipment may be entitled to a deduction for depreciation with respect to such equipment. See section 167 and the regulations thereunder.

(ii) In the case of an election to discontinue an amortization deduction under section 187, the deduction for depreciation shall be computed beginning with the first month as to which such amortization deduction is not applicable, and shall be based upon the adjusted basis (see section 1011 and the regulations thereunder) of the property as of the beginning of such month. Such depreciation deduction shall be based upon the remaining portion of the period authorized under section 167 for the facility, as determined as of the first day of the first month as of which the amortization deduction is not applicable.

(iii) In the case of a revocation of an election under section 187 referred to in paragraph (c)(2) of this section the deduction for depreciation shall begin as of the time such depreciation deduction would have been taken but for the election under section 187. See subparagraph (2) of this section for rules as to filing amended returns for years for which amortization deductions have been taken.

(d) *Examples.* This section may be illustrated by the following examples:

Example 1. On September 30, 1970, the X Corporation, which uses the calendar year as its taxable year, places in service a piece of coal mine safety equipment required as a result of the Federal Coal Mine Health and Safety Act of 1969 which is certified as indicated in paragraph (a) of §1.187–2. The cost of the equipment is $120,000. On its income tax return filed for 1970, the corporation elects to take the amortization deductions allowed by section 187(a) with respect to the equipment and to begin the 60-month amortization period with October 1970, the month following the month in which it was placed in service. The adjusted basis at the end of October 1970 (determined without regard to the amortization deduction allowed by section 187(a) for that month) is $120,000. The allowable amortization deduction with respect to such equipment for the taxable year 1970 is $6,000, computed as follows:

Monthly amortization deductions:	
October: $120,000 divided by 60	$2,000
November: $118,000 ($120,000 minus $2,000) divided by 59	2,000

December: $116,000 ($118,000 minus $2,000) divided by 58	2,000
Total amortization deduction for 1970	6,000

Example 2. Assume the same facts as in *Example 1.* Assume further that on May 20, 1972, X properly files notice of its election to discontinue the amortization deductions with the month of June 1972. The adjusted basis of the equipment as of June 1, 1972 (assuming no capital additions or improvements) is $80,000, computed as follows: Yearly amortization deductions computed in accordance with *Example 1:*

1970	$6,000
1971	24,000
1972 (for the first 5 months)	10,000
Total amortization deductions for 20 months	40,000
Adjusted basis at beginning of amortization period	120,000
Less: Amortization deductions	40,000
Adjusted basis as of June 1, 1972	80,000

Beginning as of June 1, 1972, the deduction for depreciation under section 167 is allowable with respect to the property on its adjusted basis of $80,000.

Example 3. Assume the same facts as in *Example 1,* except that on its income tax return filed in 1970, X does not elect to take amortization deductions allowed by section 187(a) but that on its income tax return filed for 1971 X elects to begin the amortization period as of January 1, 1971, the taxable year succeeding the taxable year the equipment was placed in service. Assume further that the only adjustment to basis for the period October 1, 1970, to January 1, 1971, is $3,000 for depreciation (the amount allowable, of which $2,000 is for additional first year depreciation under section 179) for the last 3 months of 1970. The adjusted basis (for determining gain) for purposes of section 187 as of that date is $120,000 less $3,000 or $117,000.

[T.D. 7137, 36 FR 14733, Aug. 11, 1971; 36 FR 16656, Aug. 25, 1971]

§ 1.187–2 Definitions.

(a) *Certified coal mine safety equipment*—(1) *In general*—(i) The term *certified coal mine safety equipment* means property which:

(*a*) Is electric face equipment (within the meaning of section 305 of the Federal Coal Mine Health and Safety Act of 1969) required in order to meet the requirements of section 305(a)(2) of such Act,

(*b*) The Secretary of the Interior or the Director of the Bureau of Mines certifies is permissible within the meaning of such section 305(a)(2), and

(*c*) Is placed in service (as defined in subparagraph (2)(i) of this paragraph) before January 1, 1975.

(ii) In addition, property placed in service in connection with any used electric face equipment which the Secretary of the Interior or the Director of the Bureau of Mines certifies makes such used electric face equipment permissible shall be treated as a separate item of certified coal mine safety equipment. See subparagraph (2)(ii) of this paragraph.

(2) *Meaning of terms.* (i) For purposes of subparagraph (1)(i)(c) of this paragraph, the term *placed in service* shall have the meaning assigned to such term in paragraph (d) of § 1.46–3.

(ii) For purposes of subparagraph (1)(ii) of this paragraph, the term *property* includes those costs of converting existing nonpermissible electric face equipment to a permissible condition which are chargeable to capital account under the principles of § 1.1016–2. Property is considered to be placed in service in connection with used electric face equipment (which was not permissible) if its use causes such electric face equipment to be certified as permissible.

(b) *Adjusted basis*—(1) *In general.* The basis upon which the deduction with respect to amortization allowed by section 187 is to be computed with respect to any item of certified coal mine safety equipment shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property (see part II (section 1011 and following) subchapter O, chapter 1 of the Code) computed as of the first day of the amortization period. For an example showing the determination of the adjusted basis referred to in the preceding sentence in the case where the amortization period begins with the taxable year succeeding the taxable year in which the property is placed in service see *Example 3* in paragraph (d) of § 1.187–1.

(2) *Capital additions.* The adjusted basis of any certified coal mine safety equipment, with respect to which an election is made under section 187(b), shall not be increased, for purposes of section 187, for amounts chargeable to

the capital account for additions or improvements after the amortization period has begun. However, nothing contained in this section or § 1.187–1 shall be deemed to disallow a deduction for depreciation for such capital additions. Thus, for example, if a taxpayer places a piece of certified coal mine safety equipment in service in 1971 and in 1972 makes improvements to it the expenditures for which are chargeable to the capital account, such improvements shall not increase the adjusted basis of the equipment for purposes of computing the amortization deduction allowed by section 187(a). However, the depreciation deduction provided by section 167 shall be allowed with respect to such improvements in accordance with the principles of section 167.

[T.D. 7137, 36 FR 14734, Aug. 11, 1971; 36 FR 19251, Oct. 1, 1971]

§ 1.188–1 Amortization of certain expenditures for qualified on-the-job training and child care facilities.

(a) *Allowance of deduction*—(1) *In general.* Under section 188, at the election of the taxpayer, any eligible expenditure (as defined in paragraph (d)(1) of this section) made by such taxpayer to acquire, construct, reconstruct, or rehabilitate section 188 property (as defined in paragraph (d)(2) of this section) shall be allowable as a deduction ratably over a period of 60 months. Such 60-month period shall begin with the month in which such property is placed in service. For rules for making the election, see paragraph (b) of this section. For rules relating to the termination of an election, see paragraph (c) of this section.

(2) *Amount of deduction*—(i) *In general.* For each eligible expenditure attributable to an item of section 188 property the amortization deduction shall be an amount, with respect to each month of the 60-month amortization period which falls within the taxable year, equal to the elgible expenditure divided by 60. The total amortization deduction with respect to each item of section 188 property for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The total amortization deduction under section 188 for a particular taxable year is the sum of the amortization deductions allowable with respect to each item of section 188 property for that taxable year.

(ii) *Separate amortization period for each expenditure.* Each eligible expenditure attributable to an item of section 188 property to which an election relates shall be amortized over a 60-month period beginning with the month in which the item of section 188 property is placed in service. Thus, if a taxpayer makes an eligible expenditure for an addition to, or improvement of, section 188 property, such expenditure must be amortized over a separate 60-month period beginning with the month in which the section 188 property is placed in service.

(iii) *Separate items.* The determination of what constitutes a separate item of section 188 property is to be made on the basis of the facts and circumstances of each individual case. Additions or improvements to an existing item of section 188 property are treated as a separate item of section 188 property. In general, each item of personal property is a separate item of property and each building, or separate element or structural component thereof, is a separate item of property. For purposes of subdivisions (i) and (ii) of this subparagraph, two or more items of property may be treated as a single item of property if such items (A) are placed in service within the same month of the taxable year, (B) have same estimated useful life, and (C) are to be used in a functionally related manner in the operation of a qualified on-the-job training or child care facility or are integrally related facilities (described in paragraph (d) (3) or (4) of this section.

(iv) *Disposition of property or termination of election.* If an item of section 188 property is sold or exchanged or otherwise disposed of (or if the item of property ceases to be used as section 188 property by the taxpayer) during a particular month, then the amortization deduction (if any) allowable to the taxpayer in respect of that item for that month shall be an amount which bears the same ratio to the amount to which the taxpayer would be entitled for a full month as the number of days in such month during which the property was held by him (or used by him as section 188 property) bears to the total number of days in such month.

(3) *Effect on other deductions.* The amortization deduction provided by section 188(a) with respect to any month shall be in lieu of any depreciation deduction which would otherwise be allowable under sections 167 or 179 with respect to that portion of the adjusted basis of the property attributable to an adjustment under section 1016(a)(1) made on account of an eligible expenditure.

(4) *Depreciation with respect to property ceasing to be used as section 188 property.* A taxpayer is entitled to a deduction for the depreciation (to the extent allowable under section 167) of property with respect to which the election under section 188 is terminated under the provisions of paragraph (c) of this section. The deduction for depreciation shall begin with the date of such termination and shall be computed on the adjusted basis of the property as of such date. The depreciation deduction shall be based upon the estimated remaining useful life and salvage value authorized under section 167 for the property as of the termination date.

(5) *Investment credit not to be allowed.* Any property with respect to which an election has been made under section 188(a) shall not be treated as section 38 property within the meaning of section 48(a).

(6) *Special rules*—(i) *Life estates.* In the case of section 188 property held by one person for life with the remainder to another person, the amortization deduction under section 188(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(ii) *Certain corporate acquistions.* If the assets of a corporation which has elected to take the amortization deduction under section 188(a) are acquired by another corporation in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the distributor or transferor corporation for purposes of this section.

(iii) *Estates and trusts.* For the allowance of the amortization deduction in the case of estates and trusts, see section 642(f) and § 1.642(f)–(1).

(iv) *Partnerships.* For the allowance of the amortization deduction in the case of partnerships, see section 703 and § 1.703–1.

(b) *Time and manner of making election*—(1) *In general.* Except as otherwise provided in subparagraph (2) of this paragraph, an election to amortize an eligible expenditure under section 188 shall be made by attaching, to the taxpayer's income tax return for the taxable period for which the deduction is first allowable to such taxpayer, a written statement containing:

(i) A description clearly identifying each item of property (or two or more items of property treated as a single item) forming a part of a qualified on-the-job training or child care facility to which the election relates. e.g., building, classroom equipment, etc.;

(ii) The date on which the eligible expenditure was made for such item of property (or the period during which eligible expenditures were made for two or more items of property treated as a single item of property);

(iii) The date on which such item of property was ''placed in service'' (see paragraph (d)(5) of this section);

(iv) The amount of the eligible expenditure of such item of property (or the total amount of expenditures for two or more items of property treated as a single item); and

(v) The annual amortization deduction claimed with respect to such item of property.

If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year for which the election is first to be made, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election.

(2) *Special rule.* With respect to any return filed before (90 days after the

date on which final regulations are filed with the Office of the Federal Register), the election to amortize an eligible expenditure for section 188 property shall be made by a statement on, or attached to, the income tax return (or an amended return) for the taxable year, indicating that an election is being made under section 188 and setting forth information to identify the election and the facility or facilities to which it applies. An election made under the provisions of this subparagraph, must be made not later than (i) the time, including extensions thereof, prescribed by law for filing the income tax return for the first taxable year for which the election is being made or (ii) before (90 days after the date on which final regulations under section 188 are filed with the Office of the Federal Register), whichever is later. Nothing in this subparagraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *No other method of making election.* No method for making the election under section 188(a) other than the method prescribed in this paragraph shall be permitted. If an election to amortize section 188 property is not made within the time and in the manner prescribed in this paragraph, no election may be made (by the filing of an amended return or in any other manner) with respect to such section 188 property.

(4) *Effect of election.* An election once made may not be revoked by a taxpayer with respect to any item of section 188 property to which the election relates. The election of the amortization deducted for an item of section 188 property shall not affect the taxpayer's right to elect or not to elect the amortization deduction as to other items of section 188 property even though the items are part of the same facility. For rules relating to the termination of an election other than by revocation by the taxpayer, see paragraph (c) of this section.

(c) *Termination of election.* If the specific use of an item of section 188 property in connection with a qualified on-the-job training or child care facility is discontinued, the election made with respect to that item of property shall be terminated. The termination shall be effective with respect to such item of property as of the earliest date on which the taxpayer's specific use of the item is no longer in connection with the operation of a qualified on-the-job training or child care facility. If a facility ceases to meet the applicable requirements of paragraph (d)(3) of this section, relating to qualified on-the-job training facilities, or paragraph (d)(4) of this section, relating to qualified child care facilities, the election or elections made with respect to the items of section 188 property comprising such facility shall be terminated. The termination shall be effective with respect to such items of poperty as of the earliest date on which the facility is no longer qualified under the applicable rules. For rules relating to depreciation with respect to property ceasing to be used as section 188 property, see paragraph (a)(4) of this section.

(d) *Definitions and special requirements*—(1) *Eligible expenditure.* For purposes of this section, the term *eligible expenditure* means an expenditure:

(i) Chargeable to capital account;

(ii) Made after December 31, 1971, and before January 1, 1982, to acquire, construct, reconstruct, or rehabilitate section 188 property which is a qualified child care center facility (or, made after December 31, 1971, and before January 1, 1977, to acquire, construct, reconstruct, or rehabilitate section 188 property which is a qualified on-the-job training facility); and

(iii) For which, but only to the extent that, a grant or other reimbursement excludable from gross income is not, directly or indirectly, payable to, or for the benefit of, the taxpayer with respect to such expenditure under any job training or child care program established or funded by the United States, a State, or any instrumentality of the foregoing, or the District of Columbia.

For purposes of this subparagraph, an expenditure is considered to be made when actually paid by a taxpayer who computes his taxable income under the cash receipts and disbursements method or when the obligation therefore is incurred by a taxpayer who computes his taxable income under the accrual method. See subparagraph (5) of this paragraph for the determination of when section 188 property is placed in service for purposes of beginning the 60-month amortization period.

(2) *Section 188 property*. Section 188 property is tangible property which is:

(i) Of a character subject to depreciation;

(ii) Located within the United States; and

(iii) Specifically used as an integral part of a qualified on-the-job training facility (as defined in subparagraph (3) of this paragraph) or as an integral part of a qualified child care center facility (as defined in subparagraph (4) of this paragraph.)

(3) *Qualified on-the-job training facility*. A *qualified on-the-job training facility* is a facility specifically used by an employer as an on-the-job training facility in connection with an occupational training program for his employees or prospective employees provided that with respect to such program:

(i) All of the following requirements are met:

(A) There is offered at the training facility a systematic program comprised of work and training and related instruction;

(B) The occupation, together with a listing of its basic skills, and the estimated schedule of time for accomplishments of such skills, are clearly identified;

(C) The content of the training is adequate to qualify the employee, or prospective employee, for the occupation for which the individual is being trained;

(D) The skills are to be imparted by competent instructors;

(E) Upon completion of the training, placement is to be based primarily upon the skills learned through the training program;

(F) The period of training is not less than the time necessary to acquire minimum job skills nor longer than the usual period of training for the same occupation; and

(G) There is reasonable certainty that employment will be available with the employer in the occupation for which the training is provided; or

(ii) The employer has entered into an agreement with the United States, or a State agency, under the provisions of the Manpower Development and Training Act of 1962, as amended and supplemented (42 U.S.C. 2571 *et seq.*), the Economic Opportunity Act of 1964, as amended and supplemented (42 U.S.C. 2701 *et seq.*), section 432(b)(1) of the Social Security Act, as amended and supplemented (42 U.S.C. 632(b)(1)), the National Apprenticeship Act of 1937, as amended and supplemented (29 U.S.C. 50 *et seq.*), or other similar Federal statute.

A *facility* consists of a building or any portion of a building and its structural components in which training is conducted, and equipment or other personal property necessary to teach a trainee the basic skills required for satisfactory performance in the occupation for which the training is being given. A facility also includes a building or portion of a building which provides essential services for trainees during the course of the training program, such as a dormitory or dining hall. For purposes of this section, a facility is considered to be specifically used as an on-the-job training facility if such facility is actually used for such purposes and is not used in a significant manner for any purpose other than job training or the furnishing of essential services for trainees such as meals and lodging. For purposes of the preceding sentence if a facility is used 20 percent of the time for a purpose other than on-the-job training or providing trainees with essential services, it would not satisfy the significant use test. Thus, a production facility is not an on-the-job training facility for purposes of section 188 simply because new employees receive training on the machines they will be using as fully productive employees. A facility is considered to be used by an employer in connection with an occupational training program for his employees or prospective employees if at least 80 percent of the trainees participating in the program are employees or prospective employees. For purposes of this section, a prospective employee is a trainee with respect to whom it is reasonably expected that the trainee will be employed by the employer upon successful completion of the training program.

(4) *Qualified child care facility.* A *qualified child care facility* is a facility which is:

(i) Particulary suited to provide child care services and specifically used by an employer to provide such services primarily for his employees' children;

(ii) Operated as a licensed or approved facility under applicable local law, if any, relating to the day care of children; and

(iii) If directly or indirectly funded to any extent by the United States, established and operated in compliance with the requirements contained in Part 71 of title 45 of the Code of Federal Regulations, relating to Federal Interagency Day Care Requirements. For purposes of this subparagraph, a *facility* consists of the buildings, or portions or structural components thereof, in which children receive such personal care protection, and supervision in the absence of their parents as may be required to meet their needs, and the equipment or other personal property necessary to render such services. Whether or not a facility, or any component property thereof, is particularly suited for the needs of the children being cared for depends upon the facts and circumstances of each individual case. Generally, a building and its structural component, or a room therein, and equipment are particulary suitable for furnishing child care service if they are designed or adapted for such use or satisfy requirements under local law for such use as a condition to granting a license for the operation of the facility. For example, such property includes special kitchen or toilet facilities connected to the building or room in which the services are rendered and equipment such as children's desks, chairs, and play or instructional equipment. Such property would not include general purpose rooms used for many purposes (for example, a room used as an employee recreation center during the evening) nor would it include a room or a part of a room which is simply screened off for use by children during the day. For purposes of this section, a facility is considered to be specifically used as a child care facility if such facility is actually used for such purpose and is not used in a significant manner for any purpose other than child care. For purposes of this subparagraph, a child care facility is used by an employer to provide child care services primarily for children of employees of the employer if, for any month, no more than 20 percent of the average daily enrolled or attending children for such month are other than children of such employees.

(5) *Placed in service.* For purposes of section 188 and this section, the term *placed in service* shall have the meaning assigned to such term in paragraph (d) of § 1.46–3.

(6) *Employees.* For purposes of section 188 and this section, the terms *employees* and *prospective employees* include employees and prospective employees of a member of a controlled group of corporations (within the meaning of section 1563) of which the taxpayer is a member.

(e) *Effective date.* The provisions of section 188 and this section apply to taxable years ending after December 31, 1971.

[T.D. 7599, 44 FR 14549, Mar. 13, 1979]

§ 1.190–1 Expenditures to remove architectural and transportation barriers to the handicapped and elderly.

(a) *In general.* Under section 190 of the Internal Revenue Code of 1954, a taxpayer may elect, in the manner provided in § 1.190–3 of this chapter, to deduct certain amounts paid or incurred by him in any taxable year beginning after December 31, 1976, and before January 1, 1980, for qualified architectural and transportation barrier removal expenses (as defined in § 1.190–2(b) of this chapter). In the case of a partnership, the election shall be made by the partnership. The election applies to expenditures paid or incurred during the taxable year which (but for the election) are chargeable to capital account.

(b) *Limitation.* The maximum deduction for a taxpayer (including an affiliated group of corporations filing a consolidated return) for any taxable year is $25,000. The $25,000 limitation applies to a partnership and to each partner.

Expenditures paid or incurred in a taxable year in excess of the amount deductible under section 190 for such taxable year are capital expenditures and are adjustments to basis under section 1016(a). A partner must combine his distributive share of the partnership's deductible expenditures (after application of the $25,000 limitation at the partnership level) with that partner's distributive share of deductible expenditures from any other partnership plus that partner's own section 190 expenditures, if any (if he makes the election with respect to his own expenditures), and apply the partner's $25,000 limitation to the combined total to determine the aggregate amount deductible by that partner. In so doing, the partner may allocate the partner's $25,000 limitation among the partner's own section 190 expenditures and the partner's distributive share of partnership deductible expenditures in any manner. If such allocation results in all or a portion of the partner's distributive share of a partnership's deductible expenditures not being an allowable deduction by the partner, the partnership may capitalize such unallowable portion by an appropriate adjustment to the basis of the relevant partnership property under section 1016. For purposes of adjustments to the basis of properties held by a partnership, however, it shall be presumed that each partner's distributive share of partnership deductible expenditures (after application of the $25,000 limitation at the partnership level) was allowable in full to the partner. This presumption can be rebutted only by clear and convincing evidence that all or any portion of a partner's distributive share of the partnership section 190 deduction was not allowable as a deduction to the partner because it exceeded that partner's $25,000 limitation as allocated by him. For example, suppose for 1978 A's distributive share of the ABC partnership's deductible section 190 expenditures (after application of the $25,000 limitation at the partnership level) is $15,000. A also made section 190 expenditures of $20,000 in 1978 which he elects to deduct. A allocates $10,000 of his $25,000 limitation to his distributive share of the ABC expenditures and $15,000 to his own expenditures. A may capitalize the excess $5,000 of his own expenditures. In addition, if ABC obtains from A evidence which meets the requisite burden of proof, it may capitalize the $5,000 of A's distributive share which is not allowable as a deduction to A.

[T.D. 7634, 44 FR 43270, July 24, 1979]

§ 1.190–2 Definitions.

For purposes of section 190 and the regulations thereunder:

(a) *Architectural and transportation barrier removal expenses.* The term *architectural and transportation barrier removal expenses* means expenditures for the purpose of making any facility, or public transportation vehicle, owned or leased by the taxpayer for use in connection with his trade or business more accessible to, or usable by, handicapped individuals or elderly individuals. For purposes of this section:

(1) The term *facility* means all or any portion of buildings, structures, equipment, roads, walks, parking lots, or similar real or personal property.

(2) The term *public transportation vehicle* means a vehicle, such as a bus, a railroad car, or other conveyance, which provides to the public general or special transportation service (including such service rendered to the customers of a taxpayer who is not in the trade or business of rendering transportation services).

(3) The term *handicapped individual* means any individual who has:

(i) A physical or mental disability (including, but not limited to, blindness or deafness) which for such individual constitutes or results in a functional limitation to employment, or

(ii) A physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more of such individual's major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

(4) The term *elderly individual* means an individual age 65 or over.

(b) *Qualified architectual and transportation barrier removal expense*—(1) *In general.* The term *qualified architectural and transportation barrier removal expense* means an architectural or transportation barrier removal expense (as defined in paragraph (a) of this section) with respect to which the taxpayer establishes, to the satisfaction of the Commissioner or his delegate, that the resulting removal of any such barrier conforms a facility or public transportation vehicle to all the requirements set forth in one or more of paragraphs (b) (2) through (22) of this section or in one or more of the subdivisions of paragraph (b) (20) or (21). Such term includes only expenses specifically attributable to the removal of an existing architectural or transportation barrier. It does not include any part of any expense paid or incurred in connection with the construction or comprehensive renovation of a facility or public transportation vehicle or the normal replacement of depreciable property. Such term may include expenses of construction, as, for example, the construction of a ramp to remove the barrier posed for wheelchair users by steps. Major portions of the standards set forth in this paragraph were adapted from ''American National Standard Specifications for Making Buildings and Facilities Accessible to, and Usable by, the Physically Handicapped'' (1971), the copyright for which is held by the American National Standards Institute, 1430 Broadway, New York, New York 10018.

(2) *Grading.* The grading of ground, even contrary to existing topography, shall attain a level with a normal entrance to make a facility accessible to individuals with physical disabilities.

(3) *Walks.* (i) A public walk shall be at least 48 inches wide and shall have a gradient not greater than 5 percent. A walk of maximum or near maximum grade and of considerable length shall have level areas at regular intervals. A walk or driveway shall have a nonslip surface.

(ii) A walk shall be of a continuing common surface and shall not be interrupted by steps or abrupt changes in level.

(iii) Where a walk crosses a walk, a driveway, or a parking lot, they shall blend to a common level. However, the preceding sentence does not require the elimination of those curbs which are a safety feature for the handicapped, particularly the blind.

(iv) An inclined walk shall have a level platform at the top and at the bottom. If a door swings out onto the platform toward the walk, such platform shall be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the walk, such platform shall be at least 3 feet deep and 5 feet wide. A platform shall extend at least 1 foot beyond the strike jamb side of any doorway.

(4) *Parking lots.* (i) At least one parking space that is accessible and approximate to a facility shall be set aside and identified for use by the handicapped.

(ii) A parking space shall be open on one side to allow room for individuals in wheelchairs and individuals on braces or crutches to get in and out of an automobile onto a level surface which is suitable for wheeling and walking.

(iii) A parking space for the handicapped, when placed between two conventional diagonal or head-on parking spaces, shall be at least 12 feet wide.

(iv) A parking space shall be positioned so that individuals in wheelchairs and individuals on braces or crutches need not wheel or walk behind parked cars.

(5) *Ramps.* (i) A ramp shall not have a slope greater than 1 inch rise in 12 inches.

(ii) A ramp shall have at least one handrail that is 32 inches in height, measured from the surface of the ramp, that is smooth, and that extends 1 foot beyond the top and bottom of the ramp. However, the preceding sentence does not require a handrail extension which is itself a hazard.

(iii) A ramp shall have a nonslip surface.

(iv) A ramp shall have a level platform at the top and at the bottom. If a door swings out onto the platform or toward the ramp, such platform shall be at least 5 feet deep and 5 feet wide. If a door does not swing onto the platform or toward the ramp, such platform shall be at least 3 feet deep and 5 feet wide. A platform shall extend at least 1 foot beyond the strike jamb side of any doorway.

(v) A ramp shall have level platforms at not more than 30-foot intervals and at any turn.

(vi) A curb ramp shall be provided at an intersection. The curb ramp shall not be less than 4 feet wide; it shall not have a slope greater than 1 inch rise in 12 inches. The transition between the two surfaces shall be smooth. A curb ramp shall have a nonslip surface.

(6) *Entrances.* A building shall have at least one primary entrance which is usable by individuals in wheelchairs and which is on a level accessible to an elevator.

(7) *Doors and doorways.* (i) A door shall have a clear opening of no less than 32 inches and shall be operable by a single effort.

(ii) The floor on the inside and outside of a doorway shall be level for a distance of at least 5 feet from the door in the direction the door swings and shall extend at least 1 foot beyond the strike jamb side of the doorway.

(iii) There shall be no sharp inclines or abrupt changes in level at a doorway. The threshold shall be flush with the floor. The door closer shall be selected, placed, and set so as not to impair the use of the door by the handicapped.

(8) *Stairs.* (i) Stairsteps shall have round nosing of between 1 and 1½ inch radius.

(ii) Stairs shall have a handrail 32 inches high as measured from the tread at the face of the riser.

(iii) Stairs shall have at least one handrail that extends at least 18 inches beyond the top step and beyond the bottom step. The preceding sentence does not require a handrail extension which is itself a hazard.

(iv) Steps shall have risers which do not exceed 7 inches.

(9) *Floors.* (i) Floors shall have a nonslip surface.

(ii) Floors on a given story of a building shall be of a common level or shall be connected by a ramp in accordance with subparagraph (5) of this paragraph.

(10) *Toilet rooms.* (i) A toilet room shall have sufficient space to allow traffic of individuals in wheelchairs.

(ii) A toilet room shall have at least one toilet stall that:

(A) Is at least 36 inches wide;

(B) Is at least 56 inches deep;

(C) Has a door, if any, that is at least 32 inches wide and swings out;

(D) Has handrails on each side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches clearance between rail and wall, and fastened securely at ends and center; and

(E) Has a water closet with a seat 19 to 20 inches from the finished floor.

(iii) A toilet room shall have, in addition to or in lieu of a toilet stall described in (ii), at least one toilet stall that:

(A) Is at least 66 inches wide;

(B) Is at least 60 inches deep;

(C) Has a door, if any, that is at least 32 inches wide and swings out;

(D) Has a handrail on one side, 33 inches high and parallel to the floor, 1½ inches in outside diameter, 1½ inches clearance between rail and wall, and fastened securely at ends and center; and

(E) Has a water closet with a seat 19 to 20 inches from the finished floor, centerline located 18 inches from the side wall on which the handrail is located.

(iv) A toilet room shall have lavatories with narrow aprons. Drain pipes and hot water pipes under a lavatory shall be covered or insulated.

(v) A mirror and a shelf above a lavatory shall be no higher than 40 inches above the floor, measured from the top of the shelf and the bottom of the mirror.

(vi) A toilet room for men shall have wall-mounted urinals with the opening of the basin 15 to 19 inches from the finished floor or shall have floor-mounted urinals that are level with the main floor of the toilet room.

(vii) Towel racks, towel dispensers, and other dispensers and disposal units shall be mounted no higher than 40 inches from the floor.

(11) *Water fountains.* (i) A water fountain and a cooler shall have upfront spouts and controls.

(ii) A water fountain and a cooler shall be hand-operated or hand-and-foot-operated.

(iii) A water fountain mounted on the side of a floor-mounted cooler shall not be more than 30 inches above the floor.

(iv) A wall-mounted, hand-operated water cooler shall be mounted with the basin 36 inches from the floor.

(v) A water fountain shall not be fully recessed and shall not be set into an alcove unless the alcove is at least 36 inches wide.

(12) *Public telephones.* (i) A public telephone shall be placed so that the dial and the headset can be reached by individuals in wheelchairs.

(ii) A public telephone shall be equipped for those with hearing disabilities and so identified with instructions for use.

(iii) Coin slots of public telephones shall be not more than 48 inches from the floor.

(13) *Elevators.* (i) An elevator shall be accessible to, and usable by the handicapped or the elderly on the levels they use to enter the building and all levels and areas normally used.

(ii) Cab size shall allow for the turning of a wheelchair. It shall measure at least 54 by 68 inches.

(iii) Door clear opening width shall be at least 32 inches.

(iv) All essential controls shall be within 48 to 54 inches from cab floor. Such controls shall be usable by the blind and shall be tactilely identifiable.

(14) *Controls.* Switches and controls for light, heat, ventilation, windows, draperies, fire alarms, and all similar controls of frequent or essential use, shall be placed within the reach of individuals in wheelchairs. Such switches and controls shall be no higher than 48 inches from the floor.

(15) *Identification.* (i) Raised letters or numbers shall be used to identify a room or an office. Such identification shall be placed on the wall to the right or left of the door at a height of 54 inches to 66 inches, measured from the finished floor.

(ii) A door that might prove dangerous if a blind person were to exit or enter by it (such as a door leading to a loading platform, boiler room, stage, or fire escape) shall be tactilely identifiable.

(16) *Warning signals.* (i) An audible warning signal shall be accompanied by a simultaneous visual signal for the benefit of those with hearing disabilities.

(ii) A visual warning signal shall be accompanied by a simultaneous audible signal for the benefit of the blind.

(17) *Hazards.* Hanging signs, ceiling lights, and similar objects and fixtures shall be placed at a minimum height of 7 feet, measured from the floor.

(18) *International accessibility symbol.* The international accessibility symbol (see illustration) shall be displayed on routes to and at wheelchair-accessible entrances to facilities and public transportation vehicles.

(19) *Additional standards for rail facilities.* (i) A rail facility shall contain a fare control area with at least one entrance with a clear opening at least 36 inches wide.

(ii) A boarding platform edge bordering a drop-off or other dangerous condition shall be marked with a warning device consisting of a strip of floor material differing in color and texture from the remaining floor surface. The gap between boarding platform and vehicle doorway shall be minimized.

(20) *Standards for buses.* (i) A bus shall have a level change mechanism (e.g., lift or ramp) to enter the bus and sufficient clearance to permit a wheelchair user to reach a secure location.

(ii) A bus shall have a wheelchair securement device. However, the preceding sentence does not require a wheelchair securement device which is itself a barrier or hazard.

(iii) The vertical distance from a curb or from street level to the first front door step shall not exceed 8 inches; the riser height for each front doorstep after the first step up from the curb or street level shall also not exceed 8 inches; and the tread depth of steps at front and rear doors shall be no less than 12 inches.

(iv) A bus shall contain clearly legible signs that indicate that seats in the front of the bus are priority seats for handicapped or elderly persons, and that encourage other passengers to make such seats available to handicapped and elderly persons who wish to use them.

(v) Handrails and stanchions shall be provided in the entranceway to the bus in a configuration that allows handicapped and elderly persons to grasp such assists from outside the bus while starting to board and to continue to use such assists throughout the boarding and fare collection processes. The configuration of the passenger assist system shall include a rail across the front of the interior of the bus located to allow passengers to lean against it while paying fares. Overhead handrails shall be continuous except for a gap at the rear doorway.

(vi) Floors and steps shall have nonslip surfaces. Step edges shall have a band of bright contrasting color running the full width of the step.

(vii) A stepwell immediately adjacent to the driver shall have, when the door is open, at least 2 foot-candles of illumination measured on the step tread. Other stepwells shall have, at all times, at least 2 foot-candles of illumination measured on the step tread.

(viii) The doorways of the bus shall have outside lighting that provides at least 1 foot-candle of illumination on the street surface for a distance of 3 feet from all points on the bottom step tread edge. Such lighting shall be located below window level and shall be shielded to protect the eyes of entering and exiting passengers.

(ix) The fare box shall be located as far forward as practicable and shall not obstruct traffic in the vestibule.

(21) *Standards for rapid and light rail vehicles.* (i) Passenger doorways on the vehicle sides shall have clear openings at least 32 inches wide.

(ii) Audible or visual warning signals shall be provided to alert handicapped and elderly persons of closing doors.

(iii) Handrails and stanchions shall be sufficient to permit safe boarding, onboard circulation, seating and standing assistance, and unboarding by handicapped and elderly persons. On a levelentry vehicle, handrails, stanchions, and seats shall be located so as to allow a wheelchair user to enter the vehicle and position the wheelchair in a location which does not obstruct the movement of other passengers. On a vehicle that requires the use of steps in the boarding process, handrails and stanchions shall be provided in the entranceway to the vehicle in a configuration that allows handicapped and elderly persons to grasp such assists from outside the vehicle while starting to board, and to continue using such assists throughout the boarding process.

(iv) Floors shall have nonslip surfaces. Step edges on a light rail vehicle shall have a band of bright contrasting color running the full width of the step.

(v) A stepwell immediately adjacent to the driver shall have, when the door is open, at least 2 foot-candles of illumination measured on the step tread. Other stepwells shall have, at all times, at least 2 foot-candles of illumination measured on the step tread.

(vi) Doorways on a light rail vehicle shall have outside lighting that provides at least 1 foot-candle of illumination on the street surface for a distance of 3 feet from all points on the bottom step tread edge. Such lighting shall be located below window level and shall be shielded to protect the eyes of entering and exiting passengers.

(22) *Other barrier removals.* The provisions of this subparagraph apply to any barrier which would not be removed by compliance with paragraphs (b)(2) through (21) of this section. The requirements of this subparagraph are:

(i) A substantial barrier to the access to or use of a facility or public transportation vehicle by handicapped or elderly individuals is removed;

(ii) The barrier which is removed had been a barrier for one or more major classes of such individuals (such as the blind, deaf, or wheelchair users); and

(iii) The removal of that barrier is accomplished without creating any new barrier that significantly impairs access to or use of the facility or vehicle by such class or classes.

[T.D. 7634, 44 FR 43270, July 24, 1979]

§ 1.190–3 Election to deduct architectural and transportation barrier removal expenses.

(a) *Manner of making election.* The election to deduct expenditures for removal of architectural and transportation barriers provided by section 190(a) shall be made by claiming the deduction as a separate item identified as such on the taxpayer's income tax return for the taxable year for which such election is to apply (or, in the case of a partnership, to the return of partnership income for such year). For the election to be valid, the return must be filed not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year for which the election is to apply.

(b) *Scope of election.* An election under section 190(a) shall apply to all expenditures described in § 1.190–2 (or in the case of a taxpayer whose architectural and transportation barrier removal expenses exceed $25,000 for the taxable year, to the $25,000 of such expenses with respect to which the deduction is claimed) paid or incurred during the taxable year for which made and shall be irrevocable after the date by which any such election must have been made.

(c) *Records to be kept.* In any case in which an election is made under section 190(a), the taxpayer shall have available, for the period prescribed by paragraph (e) of § 1.6001–1 of this chapter (Income Tax Regulations), records and documentation, including architectural plans and blueprints, contracts, and any building permits, of all the facts necessary to determine the amount of any deduction to which he is entitled by reason of the election, as well as the amount of any adjustment to basis made for expenditures in excess of the amount deductible under section 190.

[T.D. 7634, 44 FR 13273, July 24, 1979]

§ 1.193–1 Deduction for tertiary injectant expenses.

(a) *In general.* Subject to the limitations and restrictions of paragraphs (c) and (d) of this section, there shall be allowed as a deduction from gross income an amount equal to the qualified tertiary injectant expenses of the taxpayer. This deduction is allowed for the later of:

(1) The taxable year in which the injectant is injected, or

(2) The taxable year in which the expenses are paid or incurred.

(b) *Definitions*—(1) *Qualified tertiary injectant expenses.* Except as otherwise provided in this section, the term *qualified tertiary injectant expense* means any cost paid or incurred for any tertiary injectant which is used as part of a tertiary recovery method.

(2) *Tertiary recovery method. Tertiary recovery method* means:

(i) Any method which is described in subparagraphs (1) through (9) of section 212.78(c) of the June 1979 energy regulations (as defined by section 4996(b)(8)(C)),

(ii) Any method for which the taxpayer has obtained the approval of the Associate Chief Counsel (Technical), under section 4993(d)(1)(B) for purposes of Chapter 45 of the Internal Revenue Code,

(iii) Any method which is approved in the regulations under section 4993(d)(1)(B), or

(iv) Any other method to provide tertiary enhanced recovery for which the taxpayer obtains the approval of the Associate Chief Counsel (Technical) for purposes of section 193.

(c) *Special rules for hydrocarbons*—(1) *In general.* If an injectant contains more than an insignificant amount of recoverable hydrocarbons, the amount deductible under section 193 and paragraph (a) of this section shall be limited to the cost of the injectant reduced by the lesser of:

(i) The fair market value of the hydrocarbon component in the form in which it is recovered, or

(ii) The cost to the taxpayer of the hydrocarbon component of the injectant. Price levels at the time of injection are to be used in determining the fair market value of the recoverable hydrocarbons.

(2) *Presumption of recoverability.* Except to the extent that the taxpayer can demonstrate otherwise, all hydrocarbons shall be presumed recoverable and shall be presumed to have the same value on recovery that they would have if separated from the other components of the injectant before injection. Estimates based on generally accepted engineering practices may provide evidence of limitations on the amount or value of recoverable hydrocarbons.

(3) *Significant amount.* For purposes of section 193 and this section, an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

(4) *Hydrocarbon defined.* For purposes of section 193 and this section, the term *hydrocarbon* means all forms of natural gas and crude oil (which includes oil recovered from sources such as oil shale and condensate).

(5) *Injectant defined.* For purposes of applying this paragraph (c), an injectant is the substance or mixture of substances injected at a particular time. Substances injected at different times are not treated as components of a single injectant even if the injections are part of a single tertiary recovery process.

(d) *Application with other deductions.* No deduction shall be allowed under section 193 and this section for any expenditure:

(1) With respect to which the taxpayer has made an election under section 263(c) or

(2) With respect to which a deduction is allowed or allowable under any other provision of chapter 1 of the Code.

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

Example 1. B, a calendar year taxpayer why uses the cash receipts and disbursements method of accounting, uses an approved tertiary recovery method for the enhanced recovery of crude oil from one of B's oil properties. During 1980, B pays $100x for a tertiary injectant which contains 1,000y units of hydrocarbon; if separated from the other components of the injectant before injection, the hydrocarbons would have a fair market value of $80x. B uses this injectant during the recovery effort during 1981. B has not made any election under section 263(c) with respect to the expenditures for the injectant, and no section of chapter 1 of the Code other than section 193 allows a deduction for the expenditure. B is unable to demonstrate that the value of the injected hydrocarbons recovered during production will be less than $80x. B's deduction under section 193 is limited to the excess of the cost for the injectant over the fair market value of the hydrocarbon component expected to be recovered ($100x − $80x = $20x). B may claim the deduction only for 1981, the year of the injection.

Example 2. Assume the same facts as in *Example 1* except that through engineering studies B has shown that 700y units or 70 percent of the hydrocarbon injected is nonrecoverable. The recoverable hydrocarbons have a fair market value of $24x (30 percent of $80x). The recoverable hydrocarbon portion of the injectant is 24 percent of the cost of the injectant ($24x divided by $100x). The injectant does not contain a significant amount of recoverable hydrocarbons. B may claim a deduction for $100x, the entire cost of the injectant.

Example 3. Assume the same facts as in *Example 1* except that through laboratory studies B has shown that because of chemical changes in the course of production the injected hydrocarbons that are recovered will have a fair market value of only $40x. B may claim a deduction for $60x, the excess of the cost of the injectant ($100x) over the fair market value of the recoverable hydrocarbons ($40x).

Example 4. B prepares an injectant from crude oil and certain non-hydrocarbon materials purchased by B. The total cost of the injectant to B is $100x, of which $24x is attributable to the crude oil. The fair market value of the crude oil used in the injectant is $27x. B is unable to demonstrate that the value of the crude oil from the injectant that will be recovered is less than $27x. The injectant contains more than an insignificant amount of recoverable hydrocarbons because the value of the recoverable crude oil ($27x) exceeds $25x (25 percent of $100x, the cost of the injectant). Because the cost to B of the hydrocarbon component of the injectant ($24x) is less than the fair market value of the hydrocarbon component in the form in which it is recovered ($27x), the cost rather than the value is taken into account in the adjustment required under paragraph (c)(1) of this section. B's deduction under section 193 is limited to the excess of the cost of the injectant over the cost of the hydrocarbon component ($100x − $24x = $76x).

(Secs. 193 and 7805, Internal Revenue Code of 1954, 94 Stat. 286, 26 U.S.C. 193; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7980, 49 FR 39052, Oct. 3, 1984]

§ 1.194–1 Amortization of reforestation expenditures.

(a) *In general.* Section 194 allows a taxpayer to elect to amortize over an 84-month period, up to $10,000 of reforestation expenditures (as defined in § 1.194–3(c)) incurred by the taxpayer in a taxable year in connection with qualified timber property (as defined in § 1.194–3(a)). The election is not available to trusts. Only those reforestation expenditures which result in additions to capital accounts after December 31, 1979 are eligible for this special amortization.

(b) *Determination of amortization period.* The amortization period must begin on the first day of the first month of the last half of the taxable year during which the taxpayer incurs the reforestation expenditures. For example, the 84-month amortization period begins on July 1 of a taxable year for a calendar year taxpayer, regardless of whether the reforestation expenditures are incurred in January or December of that taxable year. Therefore, a taxpayer will be allowed to claim amortization deductions for only six months of each of the first and eighth taxable years of the period over which the reforestation expenditures will be amortized.

(c) *Recapture.* If a taxpayer disposes of qualified timber property within ten years of the year in which the amortizable basis was created and the taxpayer has claimed amortization deductions under section 194, part or all of any gain on the disposition may be recaptured as ordinary income. See section 1245.

[T.D. 7927, 48 FR 55849, Dec. 16, 1983]

§ 1.194–2 Amount of deduction allowable.

(a) *General rule.* The allowable monthly deduction with respect to reforestation expenditures made in a taxable year is determined by dividing the amount of reforestation expenditures made in such taxable year (after applying the limitations of paragraph (b) of this section) by 84. In order to determine the total allowable amortization deduction for a given month, a taxpayer should add the monthly amortization deductions computed under the preceding sentence for qualifying expenditures made by the taxpayer in the taxable year and the preceding seven taxable years.

(b) *Dollar limitation*—(1) *Maximum amount subject to election.* A taxpayer may elect to amortize up to $10,000 of qualifying reforestation expenditures each year under section 194. However, the maximum amortizable amount is $5,000 in the case of a married individual (as defined in section 143) filing a separate return. No carryover or carryback of expenditures in excess of $10,000 is permitted. The maximum annual amortization deduction for expenditures incurred in any taxable year is $1,428.57 ($10,000/7). The maximum deduction in the first and eighth taxable years of the amortization period is one-half that amount, or $714.29, because of the half-year convention provided in § 1.194–1(b). Total deductions for any one year under this section will reach $10,000 only if a taxpayer incurs and elects to amortize the maximum $10,000 of expenditures each year over an 8-year period.

(2) *Allocation of amortizable basis among taxpayer's timber properties.* The limit of $10,000 on amortizable reforestation expenditures applies to expenditures paid or incurred during a taxable year on all of the taxpayer's timber properties. A taxpayer who incurs more than $10,000 in qualifying expenditures

in connection with more than one qualified timber property during a taxable year may select the properties for which section 194 amortization will be elected as well as the manner in which the $10,000 limitation on amortizable basis is allocated among such properties. For example, A incurred $10,000 of qualifying reforestation expenditures on each of four properties in 1981. A may elect under section 194 to amortize $2,500 of the amount spent on each property, $5,000 of the amount spent on any two properties, the entire $10,000 spent on any one property, or A may allocate the $10,000 maximum amortizable basis among some or all of the properties in any other manner.

(3) *Basis*—(i) *In general.* Except as provided in paragraph (b)(3)(ii) of this section, the basis of a taxpayer's interest in qualified timber property for which an election is made under section 194 shall be adjusted to reflect the amount of the section 194 amortization deduction allowable to the taxpayer.

(ii) *Special rule for trusts.* Although a trust may be a partner of a partnership, income beneficiary of an estate, or (for taxable years beginning after December 31, 1982) shareholder of an S corporation, it may not deduct its allocable share of a section 194 amortization deduction allowable to such a partnership, estate, or S corporation. In addition, the basis of the interest held by the partnership, estate, or S corporation in the qualified timber property shall not be adjusted to reflect the portion of the section 194 amortization deduction that is allocable to the trust.

(4) *Allocation of amortizable basis among component members of a controlled group.* Component members of a controlled group (as defined in §1.194–3(d)) on a December 31 shall be treated as one taxpayer in applying the $10,000 limitation of paragraph (b)(1) of this section. The amortizable basis may be allocated to any one such member or allocated (for the taxable year of each such member which includes such December 31) among the several members in any manner, *Provided* That the amount of amortizable basis allocated to any member does not exceed the amount of amortizable basis actually acquired by the member in the taxable year. The allocation is to be made (i) by the common parent corporation if a consolidated return is filed for all component members of the group, or (ii) in accordance with an agreement entered into by the members of the group if separate returns are filed. If a consolidated return is filed by some component members of the group and separate returns are filed by other component members, then the common parent of the group filing the consolidated return shall enter into an agreement with those members who do not join in filing the consolidated return allocating the amount between the group filing the return and the other component members of the controlled group who do not join in filing the consolidated return. If a consolidated return is filed, the common parent corporation shall file a separate statement attached to the income tax return on which an election is made to amortize reforestation costs under section 194. See §1.194–4. If separate returns are filed by some or all component members of the group, each component member to which is allocated any part of the deduction under section 194 shall file a separate statement attached to the income tax return in which an election is made to amortize reforestation expenditures. See §1.194–4. Such statement shall include the name, address, employer identification number, and the taxable year of each component member of the controlled group, a copy of the allocation agreement signed by persons duly authorized to act on behalf of those members who file separate returns, and a description of the manner in which the deduction under section 194 has been divided among them.

(5) *Partnerships*—(i) *Election to be made by partnership.* A partnership makes the election to amortize qualified reforestation expenditures of the partnership. See section 703(b).

(ii) *Dollar limitations applicable to partnerships.* The dollar limitations of section 194 apply to the partnership as well as to each partner. Thus, a partnership may not elect to amortize more than $10,000 of reforestation expenditures under section 194 in any taxable year.

(iii) *Partner's share of amortizable basis.* Section 704 and the regulations thereunder shall govern the determination of a partner's share of a partnership's amortizable reforestation expenditures for any taxable year.

(iv) *Dollar limitation applicable to partners.* A partner shall in no event be entitled in any taxable year to claim a deduction for amortization based on more than $10,000 ($5,000 in the case of a married taxpayer who files a separate return) of amortizable basis acquired in such taxable year regardless of the source of the amortizable basis. In the case of a partner who is a member of two or more partnerships that elect under section 194, the partner's aggregate share of partnership amortizable basis may not exceed $10,000 or $5,000, whichever is applicable. In the case of a member of a partnership that elects under section 194 who also has separately acquired qualified timber property, the aggregate of the member's partnership and non-partnership amortizable basis may not exceed $10,000 or $5,000 whichever is applicable.

(6) *S corporations.* For taxable years beginning after December 31, 1982, rules similar to those contained in paragraph (b)(5) (ii) and (iv) of this section shall apply in the case of S corporations (as defined in section 1361(a)) and their shareholders.

(7) *Estates.* Estates may elect to amortize in each taxable year up to a maximum of $10,000 of qualifying reforestation expenditures under section 194. Any amortizable basis acquired by an estate shall be apportioned between the estate and the income beneficiary on the basis of the income of the estate allocable to each. The amount of amortizable basis apportioned from an estate to a beneficiary shall be taken into account in determining the $10,000 (or $5,000) amount of amortizable basis allowable to such beneficiary under this section.

(c) *Life tenant and remainderman.* If property is held by one person for life with remainder to another person, the life tenant is entitled to the full benefit of any amortization allowable under section 194 on qualifying expenditures he or she makes. Any remainder interest in the property is ignored for this purpose.

[T.D. 7927, 48 FR 55849, Dec. 16, 1983]

§ 1.194–3 Definitions.

(a) *Qualified timber property.* The term *qualified timber property* means property located in the United States which will contain trees in significant commercial quantities. The property may be a woodlot or other site but must consist of at least one acre which is planted with tree seedlings in the manner normally used in forestation or reforestation. The property must be held by the taxpayer for the growing and cutting of timber which will either be sold for use in, or used by the taxpayer in, the commercial production of timber products. A taxpayer does not have to own the property in order to be eligible to elect to amortize costs attributable to it under section 194. Thus, a taxpayer may elect to amortize qualifying reforestation expenditures incurred by such taxpayer on leased qualified timber property. Qualified timber property does not include property on which the taxpayer has planted shelter belts (for which current deductions are allowed under section 175) or ornamental trees, such as Christmas trees.

(b) *Amortizable basis.* The term *amortizable basis* means that portion of the basis of qualified timber property which is attributable to reforestation expenditures.

(c) *Reforestation expenditures*—(1) *In general.* The term *reforestation expenditures* means direct costs incurred to plant or seed for forestation or reforestation purposes. Qualifying expenditures include amounts spent for site preparation, seed or seedlings, and labor and tool costs, including depreciation on equipment used in planting or seeding. Only those costs which must be capitalized and are included in the adjusted basis of the property qualify as reforestation expenditures. Costs which are currently deductible do not qualify.

(2) *Cost-sharing programs.* Any expenditures for which the taxpayer has been reimbursed under any governmental reforestation cost-sharing program do not qualify as reforestation expenditures unless the amounts reimbursed

have been included in the gross income of the taxpayer.

(d) *Definitions of controlled group of corporations and component member of controlled group.* For purposes of section 194, the terms *controlled group of corporations* and *component member* of a controlled group of corporations shall have the same meaning assigned to those terms in section 1563 (a) and (b), except that the phrase ''more than 50 percent'' shall be substituted for the phrase ''at least 80 percent'' each place it appears in section 1563(a)(1).

[T.D. 7927, 48 FR 55850, Dec. 16, 1983]

§ 1.194–4 Time and manner of making election.

(a) *In general.* Except as provided in paragraph (b) of this section, an election to amortize reforestation expenditures under section 194 shall be made by entering the amortization deduction claimed at the appropriate place on the taxpayer's income tax return for the year in which the expenditures were incurred, and by attaching a statement to such return. The statement should state the amounts of the expenditures, describe the nature of the expenditures, and give the date on which each was incurred. The statement should also state the type of timber being grown and the purpose for which it is being grown. A separate statement must be included for each property for which reforestation expenditures are being amortized under section 194. The election may only be made on a timely return (taking into account extensions of the time for filing) for the taxable year in which the amortizable expenditures were made.

(b) *Special rule.* With respect to any return filed before March 15, 1984, on which a taxpayer was eligible to, but did not make an election under section 194, the election to amortize reforestation expenditures under section 194 may be made by a statement on, or attached to, the income tax return (or an amended return) for the taxable year, indicating that an election is being made under section 194 and setting forth the information required under paragraph (a) of this section. An election made under the provisions of this paragraph (b) must be made not later than,

(1) The time prescribed by law (including extensions thereof) for filing the income tax return for the year in which the reforestation expenditures were made, or

(2) March 15, 1984, whichever is later. Nothing in this paragraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(c) *Revocation.* An application for consent to revoke an election under section 194 shall be in writing and shall be addressed to the Commissioner of Internal Revenue, Washington, DC 20224. The application shall set forth the name and address of the taxpayer, state the taxable years for which the election was in effect, and state the reason for revoking the election. The application shall be signed by the taxpayer or a duly authorized representative of the taxpayer and shall be filed at least 90 days prior to the time prescribed by law (without regard to extensions thereof) for filing the income tax return for the first taxable year for which the election is to terminate. Ordinarily, the request for consent to revoke the election will not be granted if it appears from all the facts and circumstances that the only reason for the desired change is to obtain a tax advantage.

[T.D. 7927, 48 FR 55851, Dec. 16, 1983]

§ 1.195–1 Election to amortize start-up expenditures.

(a) *In general.* Under section 195(b), a taxpayer may elect to amortize start-up expenditures as defined in section 195(c)(1). In the taxable year in which a taxpayer begins an active trade or business, an electing taxpayer may deduct an amount equal to the lesser of the amount of the start-up expenditures that relate to the active trade or business, or $5,000 (reduced (but not below zero) by the amount by which the start-up expenditures exceed $50,000). The remainder of the start-up expenditures is deductible ratably over the 180-month period beginning with the month in which the active trade or business begins. All start-up expenditures that relate to the active trade or business are considered in determining whether the start-up expenditures exceed $50,000, including expenditures incurred on or before October 22, 2004.

(b) *Time and manner of making election.* A taxpayer is deemed to have made an election under section 195(b) to amortize start-up expenditures as defined in section 195(c)(1) for the taxable year in which the active trade or business to which the expenditures relate begins. A taxpayer may choose to forgo the deemed election by affirmatively electing to capitalize its start-up expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the active trade or business to which the expenditures relate begins. The election either to amortize start-up expenditures under section 195(b) or to capitalize start-up expenditures is irrevocable and applies to all start-up expenditures that are related to the active trade or business. A change in the characterization of an item as a start-up expenditure is a change in method of accounting to which sections 446 and 481(a) apply if the taxpayer treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the active trade or business begins also is treated as a change in method of accounting if the taxpayer amortized start-up expenditures for two or more taxable years.

(c) *Examples.* The following examples illustrate the application of this section:

Example 1. Expenditures of $5,000 or less Corporation X, a calendar year taxpayer, incurs $3,000 of start-up expenditures after October 22, 2004, that relate to an active trade or business that begins on July 1, 2011. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011. Therefore, Corporation X may deduct the entire amount of the start-up expenditures in 2011, the taxable year in which the active trade or business begins.

Example 2. Expenditures of more than $5,000 but less than or equal to $50,000 The facts are the same as in *Example 1* except that Corporation X incurs start-up expenditures of $41,000. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011. Therefore, Corporation X may deduct $5,000 and the portion of the remaining $36,000 that is allocable to July through December of 2011 ($36,000/180 × 6 = $1,200) in 2011, the taxable year in which the active trade or business begins. Corporation X may amortize the remaining $34,800 ($36,000 − $1,200 = $34,800) ratably over the remaining 174 months.

Example 3. Subsequent change in the characterization of an item The facts are the same as in *Example 2* except that Corporation X determines in 2013 that Corporation X incurred $10,000 for an additional start-up expenditure erroneously deducted in 2011 under section 162 as a business expense. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011, including the additional $10,000 of start-up expenditures. Corporation X is using an impermissible method of accounting for the additional $10,000 of start-up expenditures and must change its method under §1.446–1(e) and the applicable general administrative procedures in effect in 2013.

Example 4. Subsequent redetermination of year in which business begins The facts are the same as in *Example 2* except that, in 2012, Corporation X deducted the start-up expenditures allocable to January through December of 2012 ($36,000/180 × 12 = $2,400). In addition, in 2013 it is determined that Corporation X actually began business in 2012. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2012. Corporation X impermissibly deducted start-up expenditures in 2011, and incorrectly determined the amount of start-up expenditures deducted in 2012. Therefore, Corporation X is using an impermissible method of accounting for the start-up expenditures and must change its method under §1.446–1(e) and the applicable general administrative procedures in effect in 2013.

Example 5. Expenditures of more than $50,000 but less than or equal to $55,000 The facts are the same as in *Example 1* except that Corporation X incurs start-up expenditures of $54,500. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011. Therefore, Corporation X may deduct $500 ($5,000 − $4,500) and the portion of the remaining $54,000 that is allocable to July through December of 2011 ($54,000/180 × 6 = $1,800) in 2011, the taxable year in which the active trade or business begins. Corporation X may amortize the remaining $52,200 ($54,000 − $1,800 = $52,200) ratably over the remaining 174 months.

Example 6. Expenditures of more than $55,000 The facts are the same as in *Example 1* except that Corporation X incurs start-up expenditures of $450,000. Under paragraph (b) of this section, Corporation X is deemed to have elected to amortize start-up expenditures under section 195(b) in 2011. Therefore, Corporation X may deduct the amounts allocable to July through December of 2011 ($\$450{,}000/180 \times 6 = \$15{,}000$) in 2011, the taxable year in which the active trade or business begins. Corporation X may amortize the remaining $435,000 ($\$450{,}000 - \$15{,}000 = \$435{,}000$) ratably over the remaining 174 months.

(d) *Effective/applicability date.* This section applies to start-up expenditures paid or incurred after August 16, 2011. However, taxpayers may apply all the provisions of this section to start-up expenditures paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under paragraph (b) of this section is deemed made has not expired. For start-up expenditures paid or incurred on or before September 8, 2008, taxpayers may instead apply §1.195–1, as in effect prior to that date (§1.195–1 as contained in 26 CFR part 1 edition revised as of April 1, 2008).

[T.D. 9542, 76 FR 50888, Aug. 17, 2011]

§ 1.195–2 Technical termination of a partnership.

(a) *In general.* If a partnership that has elected to amortize start-up expenditures under section 195(b) and §1.195–1 terminates in a transaction (or a series of transactions) described in section 708(b)(1)(B) or §1.708–1(b)(2), the termination shall not be treated as resulting in a disposition of the partnership's trade or business for purposes of section 195(b)(2). See §1.708–1(b)(6) for rules concerning the treatment of these start-up expenditures by the new partnership.

(b) *Effective/applicability date.* This section applies to a technical termination of a partnership under section 708(b)(1)(B) that occurs on or after December 9, 2013.

[T.D. 9681, 79 FR 42679, July 23, 2014]

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[T.D. 8867, 65 FR 3826, Jan. 25, 2000, as amended by T.D. 9257, 71 FR 17996, Apr. 10, 2006; T.D. 9377, 73 FR 3869, Jan. 23, 2008]

§ 1.197–1T Certain elections for intangible property (temporary).

(a) *In general.* This section provides rules for making the two elections under section 13261 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). Paragraph (c) of this section provides rules for making the section 13261(g)(2) election (the retroactive election) to apply the intangibles provisions of OBRA '93 to property acquired after July 25, 1991, and on or before August 10, 1993 (the date of enactment of OBRA '93). Paragraph (d) of this section provides rules for making the section 13261(g)(3) election (binding contract election) to apply prior law to property acquired pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the date of acquisition. The provisions of this section apply only to property for which an election is made under paragraph (c) or (d) of this section.

(b) *Definitions and special rules*—(1) *Intangibles provisions of OBRA '93.* The intangibles provisions of OBRA '93 are sections 167(f) and 197 of the Internal Revenue Code (Code) and all other pertinent provisions of section 13261 of OBRA '93 (e.g., the amendment of section 1253 in the case of a franchise, trademark, or trade name).

(2) *Transition period property.* The transition period property of a taxpayer is any property that was acquired by the taxpayer after July 25, 1991, and on or before August 10, 1993.

(3) *Eligible section 197 intangibles.* The eligible section 197 intangibles of a taxpayer are any section 197 intangibles that—

(i) Are transition period property; and

(ii) Qualify as amortizable section 197 intangibles (within the meaning of section 197(c)) if an election under section 13261(g)(2) of OBRA '93 applies.

(4) *Election date.* The election date is the date (determined after application of section 7502(a)) on which the taxpayer files the original or amended return to which the election statement described in paragraph (e) of this section is attached.

(5) *Election year.* The election year is the taxable year of the taxpayer that includes August 10, 1993.

(6) *Common control.* A taxpayer is under common control with the electing taxpayer if, at any time after August 2, 1993, and on or before the election date (as defined in paragraph (b)(4) of this section), the two taxpayers would be treated as a single taxpayer under section 41(f)(1) (A) or (B).

(7) *Applicable convention for sections 197 and 167(f) intangibles.* For purposes of computing the depreciation or amortization deduction allowable with respect to transition period property described in section 167(f) (1) or (3) or with respect to eligible section 197 intangibles—

(i) Property acquired at any time during the month is treated as acquired as of the first day of the month and is eligible for depreciation or amortization during the month; and

(ii) Property is not eligible for depreciation or amortization in the month of disposition.

(8) *Application to adjustment to basis of partnership property under section 734(b) or 743(b).* Any increase in the basis of partnership property under section 734(b) (relating to the optional adjustment to basis of undistributed partnership property) or section 743(b) (relating to the optional adjustment to the basis of partnership property) will be taken into account under this section by a partner as if the increased portion of the basis were attributable to the partner's acquisition of the underlying partnership property on the date the distribution or transfer occurs. For example, if a section 754 election is in effect and, as a result of its acquisition of a partnership interest, a taxpayer obtains an increased basis in an intangible held through the partnership, the increased portion of the basis in the intangible will be treated as an intangible asset newly acquired by that taxpayer on the date of the transaction.

(9) *Former member.* A former member of a consolidated group is a corporation that was a member of the consolidated group at any time after July 25, 1991, and on or before August 2, 1993, but that is not under common control with the common parent of the group for purposes of paragraph (c)(1)(ii) of this section.

(c) *Retroactive election*—(1) *Effect of election*—(i) *On taxpayer.* Except as provided in paragraph (c)(1)(v) of this section, if a taxpayer makes the retroactive election, the intangibles provisions of OBRA '93 will apply to all the taxpayer's transition period property. Thus, for example, section 197 will apply to all the taxpayer's eligible section 197 intangibles.

(ii) *On taxpayers under common control.* If a taxpayer makes the retroactive election, the election applies to each taxpayer that is under common control with the electing taxpayer. If the retroactive election applies to a taxpayer under common control, the intangibles provisions of OBRA '93 apply to that taxpayer's transition period property in the same manner as if that taxpayer had itself made the retroactive election. However, a retroactive election that applies to a nonelecting taxpayer under common control is not treated as an election by that taxpayer for purposes of re-applying the rule of this paragraph (c)(1)(ii) to any other taxpayer.

(iii) *On former members of consolidated group.* A retroactive election by the common parent of a consolidated group applies to transition period property acquired by a former member while it was a member of the consolidated group and continues to apply to that property in each subsequent consolidated or separate return year of the former member.

(iv) *On transferred assets*—(A) *In general.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C) of this section and the intangibles provisions of OBRA '93 applied to such property in the hands of the transferor, the property remains subject to the intangibles provisions of OBRA '93 with respect to so much of its adjusted basis in the hands of the transferee as does not exceed its adjusted basis in the hands of the transferor. The transferee is not required to apply the intangibles provisions of OBRA '93 to any other transition period property that it owns, however, unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(B) *Transferee election.* If property is transferred in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section and the transferee makes the retroactive election, the transferor is not required to apply the intangibles provisions of OBRA '93 to any of its transition period property (including the property transferred to the transferee in the transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section), unless such provisions are otherwise applicable under the rules of this paragraph (c)(1).

(C) *Transactions covered.* This paragraph (c)(1)(iv) applies to—

(*1*) Any transaction described in section 332, 351, 361, 721, 731, 1031, or 1033; and

(*2*) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(D) *Exchanged basis property.* In the case of a transaction involving exchanged basis property (e.g., a transaction subject to section 1031 or 1033)—

(*1*) Paragraph (c)(1)(iv)(A) of this section shall not apply; and

(*2*) If the intangibles provisions of OBRA '93 applied to the property by reference to which the exchanged basis is determined (the predecessor property), the exchanged basis property becomes subject to the intangibles provisions of OBRA '93 with respect to so much of its basis as does not exceed the predecessor property's basis.

(E) *Acquisition date.* For purposes of paragraph (b)(2) of this section (definition of transition period property), property (other than exchanged basis property) acquired in a transaction described in paragraph (c)(1)(iv)(C)(*1*) of this section generally is treated as acquired when the transferor acquired (or was treated as acquiring) the property (or predecessor property). However, if the adjusted basis of the property in the hands of the transferee exceeds the adjusted basis of the property in the hands of the transferor, the property, with respect to that excess basis, is treated as acquired at the time of the transfer. The time at which exchanged basis property is considered acquired is determined by applying similar principles to the transferee's acquisition of predecessor property.

(v) *Special rule for property of former member of consolidated group*—(A) *Intangibles provisions inapplicable for certain periods.* If a former member of a consolidated group makes a retroactive election pursuant to paragraph (c)(1)(i) of this section or if an election applies to the former member under the common control rule of paragraph (c)(1)(ii) of this section, the intangibles provisions of OBRA '93 generally apply to all transition period property of the former member. The intangibles provisions of OBRA '93 do not apply, however, to the transition period property of a former member (including a former member that makes or is bound by a retroactive election) during the period beginning immediately after July 25, 1991, and ending immediately before the earlier of—

(*1*) The first day after July 25, 1991, that the former member was not a member of a consolidated group; or

(*2*) The first day after July 25, 1991, that the former member was a member of a consolidated group that is otherwise required to apply the intangibles provisions of OBRA '93 to its transition period property (e.g., because the common control election under paragraph (c)(1)(ii) of this section applies to the group).

(B) *Subsequent adjustments.* See paragraph (c)(5) of this section for adjustments when the intangibles provisions of OBRA '93 first apply to the transition period property of the former member after the property is acquired.

(2) *Making the election*—(i) *Partnerships, S corporations, estates, and trusts.* Except as provided in paragraph (c)(2)(ii) of this section, in the case of transition period property of a partnership, S corporation, estate, or trust, only the entity may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(ii) *Partnerships for which a section 754 election is in effect.* In the case of increased basis that is treated as transition period property of a partner under paragraph (b)(8) of this section, only that partner may make the retroactive election for purposes of paragraph (c)(1)(i) of this section.

(iii) *Consolidated groups.* An election by the common parent of a consolidated group applies to members and former members as described in paragraphs (c)(1)(ii) and (iii) of this section. Further, for purposes of paragraph (c)(1)(ii) of this section, an election by the common parent is not treated as an election by any subsidiary member. A retroactive election cannot be made by a corporation that is a subsidiary member of a consolidated group on August 10, 1993, but an election can be made on behalf of the subsidiary member under paragraph (c)(1)(ii) of this section (e.g., by the common parent of the group). See paragraph (c)(1)(iii) of this section for rules concerning the effect of the common parent's election on transition period property of a former member.

(3) *Time and manner of election*—(i) *Time.* In general, the retroactive election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) *Manner.* The retroactive election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year. In addition, the taxpayer must—

(A) Amend any previously filed return when required to do so under paragraph (c)(4) of this section; and

(B) Satisfy the notification requirements of paragraph (c)(6) of this section.

(iii) *Effect of nonconforming elections.* An attempted election that does not satisfy the requirements of this paragraph (c)(3) (including an attempted election made on a return for a taxable year prior to the election year) is not valid.

(4) *Amended return requirements*—(i) *Requirements.* A taxpayer subject to this paragraph (c)(4) must amend all previously filed income tax returns as necessary to conform the taxpayer's treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93. See paragraph (c)(5) of this section for certain adjustments that may be required on the amended returns required under this paragraph (c)(4) in the case of certain consolidated group member dispositions and tax-free transactions.

(ii) *Applicability.* This paragraph (c)(4) applies to a taxpayer if—

(A) The taxpayer makes the retroactive election; or

(B) Another person's retroactive election applies to the taxpayer or to any property acquired by the taxpayer.

(5) *Adjustment required with respect to certain consolidated group member dispositions and tax-free transactions*—(i) *Application.* This paragraph (c)(5) applies to transition period property if the intangibles provisions of OBRA '93 first apply to the property while it is held by the taxpayer but do not apply to the property for some period (the "interim period") after the property is acquired (or considered acquired) by the taxpayer. For example, this paragraph (c)(5) may apply to transition period property held by a former member of a consolidated group if a retroactive election is made by or on behalf of the former member but is not made by the consolidated group. See paragraph (c)(1)(v) of this section.

(ii) *Required adjustment to income.* If this paragraph (c)(5) applies, an adjustment must be taken into account in computing taxable income of the taxpayer for the taxable year in which the intangibles provisions of OBRA '93 first apply to the property. The amount of the adjustment is equal to the difference for the transition period property between—

(A) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) would have been permitted if the intangibles provisions of OBRA '93 applied to the property during the interim period; and

(B) The sum of the depreciation, amortization, or other cost recovery deductions that the taxpayer (and its predecessors) claimed during that interim period.

(iii) *Required adjustment to basis.* The taxpayer also must make a corresponding adjustment to the basis of its transition period property to reflect any adjustment to taxable income with respect to the property under this paragraph (c)(5).

(6) *Notification requirements*—(i) *Notification of commonly controlled taxpayers.* A taxpayer that makes the retroactive election must provide written notification of the retroactive election (on or before the election date) to each taxpayer that is under common control with the electing taxpayer.

(ii) *Notification of certain former members, former consolidated groups, and transferees.* This paragraph (c)(6)(ii) applies to a common parent of a consolidated group that makes or is notified of a retroactive election that applies to transition period property of a former member, a corporation that makes or is notified of a retroactive election that affects any consolidated group of which the corporation is a former member, or a taxpayer that makes or is notified of a retroactive election that applies to transition period property the taxpayer transfers in a transaction described in paragraph (c)(1)(iv)(C) of this section. Such common parent, former member, or transferor must provide written notification of the retroactive election to any affected former member, consolidated group, or transferee. The written notification must be provided on or before the election date in the case of an election by the common parent, former member, or transferor, and within 30 days of the election date in the case of an election by a person other than the common parent, former member, or transferor.

(7) *Revocation.* Once made, the retroactive election may be revoked only with the consent of the Commissioner.

(8) *Examples.* The following examples illustrate the application of this paragraph (c).

Example 1. (i) X is a partnership with 5 equal partners, A through E. X acquires in 1989, as its sole asset, intangible asset M. X has a section 754 election in effect for all relevant years. F, an unrelated individual, purchases A's entire interest in the X partnership in January 1993 for $700. At the time of F's purchase, X's inside basis for M is $2,000, and its fair market value is $3,500.

(ii) Under section 743(b), X makes an adjustment to increase F's basis in asset M by $300, the difference between the allocated purchase price and M's inside basis ($700 − $400 = $300). Under paragraphs (b)(8) and (c)(2)(ii) of this section, if F makes the retroactive election, the section 743(b) basis increase of $300 in M is an amortizable section 197 intangible even though asset M is not an amortizable section 197 intangible in the hands of X. F's increase in the basis of asset M is amortizable over 15 years beginning with the month of F's acquisition of the partnership interest. With respect to the remaining $400 of basis, F is treated as stepping into A's shoes and continues A's amortization (if any) in asset M. F's retroactive election applies to all other intangibles acquired by F or a taxpayer under common control with F.

Example 2. A, a calendar year taxpayer, is under common control with B, a June 30 fiscal year taxpayer. A files its original election year Federal income tax return on March 15, 1994, and does not make either the retroactive election or the binding contract election. B files its election year tax return on September 15, 1994, and makes the retroactive election. B is required by paragraph (c)(6)(i) of this section to notify A of its election. Even though A had already filed its election year return, A is bound by B's retroactive election under the common control rules. Additionally, if A had made a binding contract election, it would have been negated by B's retroactive election. Because of B's retroactive election, A must comply with the requirements of this paragraph (c), and file amended returns for the election year and any affected prior years as necessary to conform the treatment of transition period property to the treatment required under the intangibles provisions of OBRA '93.

Example 3. (i) P and Y, calendar year taxpayers, are the common parents of unrelated calendar year consolidated groups. On August 15, 1991, S, a subsidiary member of the P group, acquires a section 197 intangible with an unadjusted basis of $180. Under prior law, no amortization or depreciation was allowed with respect to the acquired intangible. On November 1, 1992, a member of the Y group acquires the S stock in a taxable transaction. On the P group's 1993 consolidated return, P makes the retroactive election. The P group also files amended returns for its affected prior years. Y does not make the retroactive election for the Y group.

(ii) Under paragraph (c)(1)(iii) of this section, a retroactive election by the common parent of a consolidated group applies to all transition period property acquired by a former member while it was a member of the group. The section 197 intangible acquired by S is transition period property that S, a former member of the P group, acquired while a member of the P group. Thus, P's election applies to the acquired asset. P must notify S of the election pursuant to paragraph (c)(6)(ii) of this section.

(iii) S amortizes the unadjusted basis of its eligible section 197 intangible ($180) over the 15-year amortization period using the applicable convention beginning as of the first day of the month of acquisition (August 1, 1991). Thus, the P group amends its 1991 consolidated tax return to take into account $5 of amortization ($180/15 years × 5⁄12 year = $5) for S.

(iv) For 1992, S is entitled to $12 of amortization ($180/15). Assume that under § 1.1502–76, $10 of S's amortization for 1992 is allocated to the P group's consolidated return and $2 is allocated to the Y group's return. The P group amends its 1992 consolidated tax return to reflect the $10 deduction for S. The Y group must amend its 1992 return to reflect the $2 deduction for S.

Example 4. (i) The facts are the same as in *Example 3,* except that the retroactive election is made for the Y group, not for the P group.

(ii) The Y group amends its 1992 consolidated return to claim a section 197 deduction of $2 ($180/15 years × 2/12 year = $2) for S.

(iii) Under paragraph (c)(1)(ii) of this section, the retroactive election by Y applies to all transition period property acquired by S. However, under paragraph (c)(1)(v)(A) of this section, the intangibles provisions of OBRA '93 do not apply to S's transition period property during the period when it held such property as a member of P group. Instead, these provisions become applicable to S's transition period property beginning on November 1, 1992, when S becomes a member of Y group.

(iv) Because the P group did not make the retroactive election, there is an interim period during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S. Thus, under paragraph (c)(5) of this section, the Y group must take into account in computing taxable income in 1992 an adjustment equal to the difference between the section 197 deduction that would have been permitted if the intangibles provisions of OBRA '93 applied to the property for the interim period (i.e., the period for which S was included in the P group's 1991 and 1992 consolidated returns) and any amortization or depreciation deductions claimed by S for the transferred intangible for that period. The retroactive election does not affect the P group, and the P group is not required to amend its returns.

Example 5. The facts are the same as in *Example 3,* except that both P and Y make the retroactive election. P must notify S of its election pursuant to paragraph (c)(6)(ii) of this section. Further, both the P and Y groups must file amended returns for affected prior years. Because there is no period of time during which the intangibles provisions of OBRA '93 do not apply to the asset acquired by S, the Y group is permitted no adjustment under paragraph (c)(5) of this section for the asset.

(d) *Binding contract election*—(1) *General rule*—(i) *Effect of election.* If a taxpayer acquires property pursuant to a written binding contract in effect on August 10, 1993, and at all times thereafter before the acquisition (an eligible acquisition) and makes the binding contract election with respect to the contract, the law in effect prior to the enactment of OBRA '93 will apply to all property acquired pursuant to the contract. A separate binding contract election must be made with respect to each eligible acquisition to which the law in effect prior to the enactment of OBRA '93 is to apply.

(ii) *Taxpayers subject to retroactive election.* A taxpayer may not make the binding contract election if the taxpayer or a person under common control with the taxpayer makes the retroactive election under paragraph (c) of this section.

(iii) *Revocation.* A binding contract election, once made, may be revoked only with the consent of the Commissioner.

(2) *Time and manner of election*—(i) *Time.* In general, the binding contract election must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the election year. If, however, the taxpayer's original Federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994.

(ii) *Manner.* The binding contract election is made by attaching the election statement described in paragraph (e) of this section to the taxpayer's original or amended income tax return for the election year.

(iii) *Effect of nonconforming election.* An attempted election that does not satisfy the requirements of this paragraph (d)(2) is not valid.

(e) *Election statement*—(1) *Filing requirements*. For an election under paragraph (c) or (d) of this section to be valid, the electing taxpayer must:

(i) File (with its Federal income tax return for the election year and with any affected amended returns required under paragraph (c)(4) of this section) a written election statement, as an attachment to Form 4562 (Depreciation and Amortization), that satisfies the requirements of paragraph (e)(2) of this section; and

(ii) Forward a copy of the election statement to the Statistics Branch (QAM:S:6111), IRS Ogden Service Center, ATTN: Chief, Statistics Branch, P.O. Box 9941, Ogden, UT 84409.

(2) *Content of the election statement*. The written election statement must include the information in paragraphs (e)(2) (i) through (vi) and (ix) of this section in the case of a retroactive election, and the information in paragraphs (e)(2) (i) and (vii) through (ix) of this section in the case of a binding contract election. The required information should be arranged and identified in accordance with the following order and numbering system—

(i) The name, address and taxpayer identification number (TIN) of the electing taxpayer (and the common parent if a consolidated return is filed).

(ii) A statement that the taxpayer is making the retroactive election.

(iii) Identification of the transition period property affected by the retroactive election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and the amount of depreciation, amortization, or other cost recovery under section 167 or any other provision of the Code claimed with respect to the property.

(iv) Identification of each taxpayer under common control (as defined in paragraph (b)(6) of this section) with the electing taxpayer by name, TIN, and Internal Revenue Service Center where the taxpayer's income tax return is filed.

(v) If any persons are required to be notified of the retroactive election under paragraph (c)(6) of this section, identification of such persons and certification that written notification of the election has been provided to such persons.

(vi) A statement that the transition period property being amortized under section 197 is not subject to the anti-churning rules of section 197(f)(9).

(vii) A statement that the taxpayer is making the binding contract election.

(viii) Identification of the property affected by the binding contract election, the name and TIN of the person from which the property was acquired, the manner and date of acquisition, the basis at which the property was acquired, and whether any of the property is subject to depreciation under section 167 or to amortization or other cost recovery under any other provision of the Code.

(ix) The signature of the taxpayer or an individual authorized to sign the taxpayer's Federal income tax return.

(f) *Effective date*. These regulations are effective March 15, 1994.

[T.D. 8528, 59 FR 11920, Mar. 15, 1994, as amended by T.D. 9377, 73 FR 3869, Jan. 23, 2008]

§ 1.197–2 Amortization of goodwill and certain other intangibles.

(a) *Overview*—(1) *In general*. Section 197 allows an amortization deduction for the capitalized costs of an amortizable section 197 intangible and prohibits any other depreciation or amortization with respect to that property. Paragraphs (b), (c), and (e) of this section provide rules and definitions for determining whether property is a section 197 intangible, and paragraphs (d) and (e) of this section provide rules and definitions for determining whether a section 197 intangible is an amortizable section 197 intangible. The amortization deduction under section 197 is determined by amortizing basis ratably over a 15-year period under the rules of paragraph (f) of this section. Section 197 also includes various special rules pertaining to the disposition of amortizable section 197 intangibles, nonrecognition transactions, anti-churning rules, and anti-abuse rules. Rules relating to these provisions are contained in paragraphs (g), (h), and (j) of this section. Examples demonstrating the application of these provisions are contained in paragraph (k) of this section. The effective date of the rules in this section is contained in paragraph (l) of this section.

(2) *Section 167(f) property.* Section 167(f) prescribes rules for computing the depreciation deduction for certain property to which section 197 does not apply. See §1.167(a)–14 for rules under section 167(f) and paragraphs (c)(4), (6), (7), (11), and (13) of this section for a description of the property subject to section 167(f).

(3) *Amounts otherwise deductible.* Section 197 does not apply to amounts that are not chargeable to capital account under paragraph (f)(3) (relating to basis determinations for covenants not to compete and certain contracts for the use of section 197 intangibles) of this section and are otherwise currently deductible. For this purpose, an amount described in §1.162–11 is not currently deductible if, without regard to §1.162–11, such amount is properly chargeable to capital account.

(b) *Section 197 intangibles; in general.* Except as otherwise provided in paragraph (c) of this section, the term *section 197 intangible* means any property described in section 197(d)(1). The following rules and definitions provide guidance concerning property that is a section 197 intangible unless an exception applies:

(1) *Goodwill.* Section 197 intangibles include goodwill. Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.

(2) *Going concern value.* Section 197 intangibles include going concern value. Going concern value is the additional value that attaches to property by reason of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership, but does not include any of the intangibles described in any other provision of this paragraph (b). It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.

(3) *Workforce in place.* Section 197 intangibles include workforce in place. Workforce in place (sometimes referred to as agency force or assembled workforce) includes the composition of a workforce (for example, the experience, education, or training of a workforce), the terms and conditions of employment whether contractual or otherwise, and any other value placed on employees or any of their attributes. Thus, the amount paid or incurred for workforce in place includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a highly-skilled workforce, an existing employment contract (or contracts), or a relationship with employees or consultants (including, but not limited to, any key employee contract or relationship). Workforce in place does not include any covenant not to compete or other similar arrangement described in paragraph (b)(9) of this section.

(4) *Information base.* Section 197 intangibles include any information base, including a customer-related information base. For this purpose, an information base includes business books and records, operating systems, and any other information base (regardless of the method of recording the information) and a customer-related information base is any information base that includes lists or other information with respect to current or prospective customers. Thus, the amount paid or incurred for information base includes, for example, any portion of the purchase price of an acquired trade or business attributable to the intangible value of technical manuals, training manuals or programs, data files, and accounting or inventory control systems. Other examples include the cost of acquiring customer lists, subscription lists, insurance expirations, patient or client files, or lists of newspaper, magazine, radio, or television advertisers.

(5) *Know-how, etc.* Section 197 intangibles include any patent, copyright,

formula, process, design, pattern, know-how, format, package design, computer software (as defined in paragraph (c)(4)(iv) of this section), or interest in a film, sound recording, video tape, book, or other similar property. (See, however, the exceptions in paragraph (c) of this section.)

(6) *Customer-based intangibles*. Section 197 intangibles include any customer-based intangible. A customer-based intangible is any composition of market, market share, or other value resulting from the future provision of goods or services pursuant to contractual or other relationships in the ordinary course of business with customers. Thus, the amount paid or incurred for customer-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a customer base, a circulation base, an undeveloped market or market growth, insurance in force, the existence of a qualification to supply goods or services to a particular customer, a mortgage servicing contract (as defined in paragraph (c)(11) of this section), an investment management contract, or other relationship with customers involving the future provision of goods or services. (See, however, the exceptions in paragraph (c) of this section.) In addition, customer-based intangibles include the deposit base and any similar asset of a financial institution. Thus, the amount paid or incurred for customer-based intangibles also includes any portion of the purchase price of an acquired financial institution attributable to the value represented by existing checking accounts, savings accounts, escrow accounts, and other similar items of the financial institution. However, any portion of the purchase price of an acquired trade or business attributable to accounts receivable or other similar rights to income for goods or services provided to customers prior to the acquisition of a trade or business is not an amount paid or incurred for a customer-based intangible.

(7) *Supplier-based intangibles*—(i) *In general*. Section 197 intangibles include any supplier-based intangible. A *supplier-based intangible* is the value resulting from the future acquisition, pursuant to contractual or other relationships with suppliers in the ordinary course of business, of goods or services that will be sold or used by the taxpayer. Thus, the amount paid or incurred for supplier-based intangibles includes, for example, any portion of the purchase price of an acquired trade or business attributable to the existence of a favorable relationship with persons providing distribution services (such as favorable shelf or display space at a retail outlet), or the existence of favorable supply contracts. The amount paid or incurred for supplier-based intangibles does not include any amount required to be paid for the goods or services themselves pursuant to the terms of the agreement or other relationship. In addition, see the exceptions in paragraph 2(c) of this section, including the exception in paragraph 2(c)(6) of this section for certain rights to receive tangible property or services from another person.

(ii) *Applicability date*. This section applies to supplier-based intangibles acquired after July 6, 2011.

(8) *Licenses, permits, and other rights granted by governmental units*. Section 197 intangibles include any license, permit, or other right granted by a governmental unit (including, for purposes of section 197, an agency or instrumentality thereof) even if the right is granted for an indefinite period or is reasonably expected to be renewed for an indefinite period. These rights include, for example, a liquor license, a taxi-cab medallion (or license), an airport landing or takeoff right (sometimes referred to as a slot), a regulated airline route, or a television or radio broadcasting license. The issuance or renewal of a license, permit, or other right granted by a governmental unit is considered an acquisition of the license, permit, or other right. (See, however, the exceptions in paragraph (c) of this section, including the exceptions in paragraph (c)(3) of this section for an interest in land, paragraph (c)(6) of this section for certain rights to receive tangible property or services, paragraph (c)(8) of this section for an interest under a lease of tangible property, and paragraph (c)(13) of this section for certain rights granted by a governmental unit. See paragraph

(b)(10) of this section for the treatment of franchises.)

(9) *Covenants not to compete and other similar arrangements.* Section 197 intangibles include any covenant not to compete, or agreement having substantially the same effect, entered into in connection with the direct or indirect acquisition of an interest in a trade or business or a substantial portion thereof. For purposes of this paragraph (b)(9), an acquisition may be made in the form of an asset acquisition (including a qualified stock purchase that is treated as a purchase of assets under section 338), a stock acquisition or redemption, and the acquisition or redemption of a partnership interest. An agreement requiring the performance of services for the acquiring taxpayer or the provision of property or its use to the acquiring taxpayer does not have substantially the same effect as a covenant not to compete to the extent that the amount paid under the agreement represents reasonable compensation for the services actually rendered or for the property or use of the property actually provided.

(10) *Franchises, trademarks, and trade names.* (i) Section 197 intangibles include any franchise, trademark, or trade name. The term *franchise* has the meaning given in section 1253(b)(1) and includes any agreement that provides one of the parties to the agreement with the right to distribute, sell, or provide goods, services, or facilities, within a specified area. The term *trademark* includes any word, name, symbol, or device, or any combination thereof, adopted and used to identify goods or services and distinguish them from those provided by others. The term *trade name* includes any name used to identify or designate a particular trade or business or the name or title used by a person or organization engaged in a trade or business. A license, permit, or other right granted by a governmental unit is a franchise if it otherwise meets the definition of a franchise. A trademark or trade name includes any trademark or trade name arising under statute or applicable common law, and any similar right granted by contract. The renewal of a franchise, trademark, or trade name is treated as an acquisition of the franchise, trademark, or trade name.

(ii) Notwithstanding the definitions provided in paragraph (b)(10)(i) of this section, any amount that is paid or incurred on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name and that is subject to section 1253(d)(1) is not included in the basis of a section 197 intangible. (See paragraph (g)(6) of this section.)

(11) *Contracts for the use of, and term interests in, section 197 intangibles.* Section 197 intangibles include any right under a license, contract, or other arrangement providing for the use of property that would be a section 197 intangible under any provision of this paragraph (b) (including this paragraph (b)(11)) after giving effect to all of the exceptions provided in paragraph (c) of this section. Section 197 intangibles also include any term interest (whether outright or in trust) in such property.

(12) *Other similar items.* Section 197 intangibles include any other intangible property that is similar in all material respects to the property specifically described in section 197(d)(1)(C)(i) through (v) and paragraphs (b)(3) through (7) of this section. (See paragraph (g)(5) of this section for special rules regarding certain reinsurance transactions.)

(c) *Section 197 intangibles; exceptions.* The term *section 197 intangible* does not include property described in section 197(e). The following rules and definitions provide guidance concerning property to which the exceptions apply:

(1) *Interests in a corporation, partnership, trust, or estate.* Section 197 intangibles do not include an interest in a corporation, partnership, trust, or estate. Thus, for example, amortization under section 197 is not available for the cost of acquiring stock, partnership interests, or interests in a trust or estate, whether or not the interests are regularly traded on an established market. (See paragraph (g)(3) of this section for special rules applicable to property of a partnership when a section 754 election is in effect for the partnership.)

(2) *Interests under certain financial contracts.* Section 197 intangibles do not

include an interest under an existing futures contract, foreign currency contract, notional principal contract, interest rate swap, or other similar financial contract, whether or not the interest is regularly traded on an established market. However, this exception does not apply to an interest under a mortgage servicing contract, credit card servicing contract, or other contract to service another person's indebtedness, or an interest under an assumption reinsurance contract. (See paragraph (g)(5) of this section for the treatment of assumption reinsurance contracts. See paragraph (c)(11) of this section and § 1.167(a)–14(d) for the treatment of mortgage servicing rights.)

(3) *Interests in land.* Section 197 intangibles do not include any interest in land. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base. An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement.

(4) *Certain computer software*—(i) *Publicly available.* Section 197 intangibles do not include any interest in computer software that is (or has been) readily available to the general public on similar terms, is subject to a nonexclusive license, and has not been substantially modified. Computer software will be treated as readily available to the general public if the software may be obtained on substantially the same terms by a significant number of persons that would reasonably be expected to use the software. This requirement can be met even though the software is not available through a system of retail distribution. Computer software will not be considered to have been substantially modified if the cost of all modifications to the version of the software that is readily available to the general public does not exceed the greater of 25 percent of the price at which the unmodified version of the software is readily available to the general public or $2,000. For the purpose of determining whether computer software has been substantially modified—

(A) Integrated programs acquired in a package from a single source are treated as a single computer program; and

(B) Any cost incurred to install the computer software on a system is not treated as a cost of the software. However, the costs for customization, such as tailoring to a user's specifications (other than embedded programming options) are costs of modifying the software.

(ii) *Not acquired as part of trade or business.* Section 197 intangibles do not include an interest in computer software that is not acquired as part of a purchase of a trade or business.

(iii) *Other exceptions.* For other exceptions applicable to computer software, see paragraph (a)(3) of this section (relating to otherwise deductible amounts) and paragraph (g)(7) of this section (relating to amounts properly taken into account in determining the cost of property that is not a section 197 intangible).

(iv) *Computer software defined.* For purposes of this section, computer software is any program or routine (that is, any sequence of machine-readable code) that is designed to cause a computer to perform a desired function or set of functions, and the documentation required to describe and maintain that program or routine. It includes all forms and media in which the software is contained, whether written, magnetic, or otherwise. Computer programs of all classes, for example, operating systems, executive systems, monitors, compilers and translators, assembly routines, and utility programs as well as application programs, are included. Computer software also includes any incidental and ancillary rights that are necessary to effect the acquisition of the title to, the ownership of, or the right to use the computer software, and that are used only in connection with that specific computer software. Such incidental and ancillary rights are not included in the definition of trademark or trade name under paragraph (b)(10)(i) of this section. For example, a trademark or trade name that is ancillary to the ownership or use of a specific computer software program in the taxpayer's trade or business and is not acquired for the purpose of marketing the computer software is included in the definition of computer software and is not included in the definition of trademark or trade name. Computer software does not include any data or information base described in paragraph (b)(4) of this section unless the data base or item is in the public domain and is incidental to a computer program. For this purpose, a copyrighted or proprietary data or information base is treated as in the public domain if its availability through the computer program does not contribute significantly to the cost of the program. For example, if a word-processing program includes a dictionary feature used to spell-check a document or any portion thereof, the entire program (including the dictionary feature) is computer software regardless of the form in which the feature is maintained or stored.

(5) *Certain interests in films, sound recordings, video tapes, books, or other similar property*. Section 197 intangibles do not include any interest (including an interest as a licensee) in a film, sound recording, video tape, book, or other similar property (such as the right to broadcast or transmit a live event) if the interest is not acquired as part of a purchase of a trade or business. A film, sound recording, video tape, book, or other similar property includes any incidental and ancillary rights (such as a trademark or trade name) that are necessary to effect the acquisition of title to, the ownership of, or the right to use the property and are used only in connection with that property. Such incidental and ancillary rights are not included in the definition of trademark or trade name under paragraph (b)(10)(i) of this section. For purposes of this paragraph (c)(5), computer software (as defined in paragraph (c)(4)(iv) of this section) is not treated as other property similar to a film, sound recording, video tape, or book. (See section 167 for amortization of excluded intangible property or interests.)

(6) *Certain rights to receive tangible property or services*. Section 197 intangibles do not include any right to receive tangible property or services under a contract or from a governmental unit if the right is not acquired as part of a purchase of a trade or business. Any right that is described in the preceding sentence is not treated as a section 197 intangible even though the right is also described in section 197(d)(1)(D) and paragraph (b)(8) of this section (relating to certain governmental licenses, permits, and other rights) and even though the right fails to meet one or more of the requirements of paragraph (c)(13) of this section (relating to certain rights of fixed duration or amount). (See §1.167(a)–14(c) (1) and (3) for applicable rules.)

(7) *Certain interests in patents or copyrights*. Section 197 intangibles do not include any interest (including an interest as a licensee) in a patent, patent application, or copyright that is not acquired as part of a purchase of a trade or business. A patent or copyright includes any incidental and ancillary rights (such as a trademark or trade name) that are necessary to effect the acquisition of title to, the ownership of, or the right to use the property and are used only in connection with that property. Such incidental and ancillary rights are not included in the definition of trademark or trade name under paragraph (b)(10)(i) of this section. (See §1.167(a)–14(c)(4) for applicable rules.)

(8) *Interests under leases of tangible property*—(i) *Interest as a lessor*. Section 197 intangibles do not include any interest as a lessor under an existing lease or sublease of tangible real or personal property. In addition, the cost of acquiring an interest as a lessor in connection with the acquisition of tangible property is taken into account as part of the cost of the tangible property. For example, if a taxpayer acquires a shopping center that is leased to tenants operating retail stores, any portion of the purchase price attributable to favorable lease terms is taken into account as part of the basis of the shopping center and in determining the depreciation deduction allowed with respect to the shopping center. (See section 167(c)(2).)

(ii) *Interest as a lessee.* Section 197 intangibles do not include any interest as a lessee under an existing lease of tangible real or personal property. For this purpose, an airline lease of an airport passenger or cargo gate is a lease of tangible property. The cost of acquiring such an interest is taken into account under section 178 and § 1.162–11(a). If an interest as a lessee under a lease of tangible property is acquired in a transaction with any other intangible property, a portion of the total purchase price may be allocable to the interest as a lessee based on all of the relevant facts and circumstances.

(9) *Interests under indebtedness*—(i) *In general.* Section 197 intangibles do not include any interest (whether as a creditor or debtor) under an indebtedness in existence when the interest was acquired. Thus, for example, the value attributable to the assumption of an indebtedness with a below-market interest rate is not amortizable under section 197. In addition, the premium paid for acquiring a debt instrument with an above-market interest rate is not amortizable under section 197. See section 171 for rules concerning the treatment of amortizable bond premium.

(ii) *Exceptions.* For purposes of this paragraph (c)(9), an interest under an existing indebtedness does not include the deposit base (and other similar items) of a financial institution. An interest under an existing indebtedness includes mortgage servicing rights, however, to the extent the rights are stripped coupons under section 1286.

(10) *Professional sports franchises.* Section 197 intangibles do not include any franchise to engage in professional baseball, basketball, football, or any other professional sport, and any item (even though otherwise qualifying as a section 197 intangible) acquired in connection with such a franchise.

(11) *Mortgage servicing rights.* Section 197 intangibles do not include any right described in section 197(e)(7) (concerning rights to service indebtedness secured by residential real property that are not acquired as part of a purchase of a trade or business). (See § 1.167(a)–14(d) for applicable rules.)

(12) *Certain transaction costs.* Section 197 intangibles do not include any fees for professional services and any transaction costs incurred by parties to a transaction in which all or any portion of the gain or loss is not recognized under part III of subchapter C of the Internal Revenue Code.

(13) *Rights of fixed duration or amount.* (i) Section 197 intangibles do not include any right under a contract or any license, permit, or other right granted by a governmental unit if the right—

(A) Is acquired in the ordinary course of a trade or business (or an activity described in section 212) and not as part of a purchase of a trade or business;

(B) Is not described in section 197(d)(1)(A), (B), (E), or (F);

(C) Is not a customer-based intangible, a customer-related information base, or any other similar item; and

(D) Either—

(*1*) Has a fixed duration of less than 15 years; or

(*2*) Is fixed as to amount and the adjusted basis thereof is properly recoverable (without regard to this section) under a method similar to the unit-of-production method.

(ii) See § 1.167(a)–14(c)(2) and (3) for applicable rules.

(d) *Amortizable section 197 intangibles*—(1) *Definition.* Except as otherwise provided in this paragraph (d), the term *amortizable section 197 intangible* means any section 197 intangible acquired after August 10, 1993 (or after July 25, 1991, if a valid retroactive election under § 1.197–1T has been made), and held in connection with the conduct of a trade or business or an activity described in section 212.

(2) *Exception for self-created intangibles*—(i) *In general.* Except as provided in paragraph (d)(2)(iii) of this section, amortizable section 197 intangibles do not include any section 197 intangible created by the taxpayer (a self-created intangible).

(ii) *Created by the taxpayer*—(A) *Defined.* A section 197 intangible is created by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs for its creation, production, development, or improvement, whether the actual work is performed by the taxpayer or by another person under a contract with the taxpayer entered into before the contracted creation, production, development, or improvement occurs. For example, a technological process developed specifically for a taxpayer under an arrangement with another person pursuant to which the taxpayer retains all rights to the process is created by the taxpayer.

(B) *Contracts for the use of intangibles.* A section 197 intangible is not a self-created intangible to the extent that it results from the entry into (or renewal of) a contract for the use of an existing section 197 intangible. Thus, for example, the exception for self-created intangibles does not apply to capitalized costs, such as legal and other professional fees, incurred by a licensee in connection with the entry into (or renewal of) a contract for the use of know-how or similar property.

(C) *Improvements and modifications.* If an existing section 197 intangible is improved or otherwise modified by the taxpayer or by another person under a contract with the taxpayer, the existing intangible and the capitalized costs (if any) of the improvements or other modifications are each treated as a separate section 197 intangible for purposes of this paragraph (d).

(iii) *Exceptions.* (A) The exception for self-created intangibles does not apply to any section 197 intangible described in section 197(d)(1)(D) (relating to licenses, permits or other rights granted by a governmental unit), 197(d)(1)(E) (relating to covenants not to compete), or 197(d)(1)(F) (relating to franchises, trademarks, and trade names). Thus, for example, capitalized costs incurred in the development, registration, or defense of a trademark or trade name do not qualify for the exception and are amortized over 15 years under section 197.

(B) The exception for self-created intangibles does not apply to any section 197 intangible created in connection with the purchase of a trade or business (as defined in paragraph (e) of this section).

(C) If a taxpayer disposes of a self-created intangible and subsequently reacquires the intangible in an acquisition described in paragraph (h)(5)(ii) of this section, the exception for self-created intangibles does not apply to the reacquired intangible.

(3) *Exception for property subject to anti-churning rules.* Amortizable section 197 intangibles do not include any property to which the anti-churning rules of section 197(f)(9) and paragraph (h) of this section apply.

(e) *Purchase of a trade or business.* Several of the exceptions in section 197 apply only to property that is not acquired in (or created in connection with) a transaction or series of related transactions involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Property acquired in (or created in connection with) such a transaction or series of related transactions is referred to in this section as property acquired as part of (or created in connection with) a purchase of a trade or business. For purposes of section 197 and this section, the applicability of the limitation is determined under the following rules:

(1) *Goodwill or going concern value.* An asset or group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060 (that is, if goodwill or going concern value could under any circumstances attach to the assets). See §1.1060–1(b)(2). For this purpose, all the facts and circumstances, including any employee relationships that continue (or covenants not to compete that are entered into) as part of the transfer of the assets, are taken into account in determining whether goodwill or going concern value could attach to the assets.

(2) *Franchise, trademark, or trade name*—(i) *In general.* The acquisition of a franchise, trademark, or trade name constitutes the acquisition of a trade or business or a substantial portion thereof.

(ii) *Exceptions.* For purposes of this paragraph (e)(2)—

(A) A trademark or trade name is disregarded if it is included in computer software under paragraph (c)(4) of this section or in an interest in a film, sound recording, video tape, book, or other similar property under paragraph (c)(5) of this section;

(B) A franchise, trademark, or trade name is disregarded if its value is nominal or the taxpayer irrevocably disposes of it immediately after its acquisition; and

(C) The acquisition of a right or interest in a trademark or trade name is disregarded if the grant of the right or interest is not, under the principles of section 1253, a transfer of all substantial rights to such property or of an undivided interest in all substantial rights to such property.

(3) *Acquisitions to be included.* The assets acquired in a transaction (or series of related transactions) include only assets (including a beneficial or other indirect interest in assets where the interest is of a type described in paragraph (c)(1) of this section) acquired by the taxpayer and persons related to the taxpayer from another person and persons related to that other person. For purposes of this paragraph (e)(3), persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1).

(4) *Substantial portion.* The determination of whether acquired assets constitute a substantial portion of a trade or business is to be based on all of the facts and circumstances, including the nature and the amount of the assets acquired as well as the nature and amount of the assets retained by the transferor. The value of the assets acquired relative to the value of the assets retained by the transferor is not determinative of whether the acquired assets constitute a substantial portion of a trade or business.

(5) *Deemed asset purchases under section 338.* A qualified stock purchase that is treated as a purchase of assets under section 338 is treated as a transaction involving the acquisition of assets constituting a trade or business only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business or a substantial portion thereof.

(6) *Mortgage servicing rights.* Mortgage servicing rights acquired in a transaction or series of related transactions are disregarded in determining for purposes of paragraph (c)(11) of this section whether the assets acquired in the transaction or transactions constitute a trade or business or substantial portion thereof.

(7) *Computer software acquired for internal use.* Computer software acquired in a transaction or series of related transactions solely for internal use in an existing trade or business is disregarded in determining for purposes of paragraph (c)(4) of this section whether the assets acquired in the transaction or series of related transactions constitute a trade or business or substantial portion thereof.

(f) *Computation of amortization deduction*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, the amortization deduction allowable under section 197(a) is computed as follows:

(i) The basis of an amortizable section 197 intangible is amortized ratably over the 15-year period beginning on the later of—

(A) The first day of the month in which the property is acquired; or

(B) In the case of property held in connection with the conduct of a trade or business or in an activity described in section 212, the first day of the month in which the conduct of the trade or business or the activity begins.

(ii) Except as otherwise provided in this section, basis is determined under section 1011 and salvage value is disregarded.

(iii) Property is not eligible for amortization in the month of disposition.

(iv) The amortization deduction for a short taxable year is based on the number of months in the short taxable year.

(2) *Treatment of contingent amounts*—(i) *Amounts added to basis during 15-year period.* Any amount that is properly included in the basis of an amortizable section 197 intangible after the first month of the 15-year period described in paragraph (f)(1)(i) of this section and before the expiration of that period is amortized ratably over the remainder of the 15-year period. For this purpose, the remainder of the 15-year period begins on the first day of the month in which the basis increase occurs.

(ii) *Amounts becoming fixed after expiration of 15-year period.* Any amount that is not properly included in the basis of an amortizable section 197 intangible until after the expiration of the 15-year period described in paragraph (f)(1)(i) of this section is amortized in full immediately upon the inclusion of the amount in the basis of the intangible.

(iii) *Rules for including amounts in basis.* See §§ 1.1275–4(c)(4) and 1.483–4(a) for rules governing the extent to which contingent amounts payable under a debt instrument given in consideration for the sale or exchange of an amortizable section 197 intangible are treated as payments of principal and the time at which the amount treated as principal is included in basis. See § 1.461–1(a)(1) and (2) for rules governing the time at which other contingent amounts are taken into account in determining the basis of an amortizable section 197 intangible.

(3) *Basis determinations for certain assets*—(i) *Covenants not to compete.* In the case of a covenant not to compete or other similar arrangement described in paragraph (b)(9) of this section (a covenant), the amount chargeable to capital account includes, except as provided in this paragraph (f)(3), all amounts that are required to be paid pursuant to the covenant, whether or not any such amount would be deductible under section 162 if the covenant were not a section 197 intangible.

(ii) *Contracts for the use of section 197 intangibles; acquired as part of a trade or business*—(A) *In general.* Except as provided in this paragraph (f)(3), any amount paid or incurred by the transferee on account of the transfer of a right or term interest described in paragraph (b)(11) of this section (relating to contracts for the use of, and term interests in, section 197 intangibles) by the owner of the property to which such right or interest relates and as part of a purchase of a trade or business is chargeable to capital account, whether or not such amount would be deductible under section 162 if the property were not a section 197 intangible.

(B) *Know-how and certain information base.* The amount chargeable to capital account with respect to a right or term interest described in paragraph (b)(11) of this section is determined without regard to the rule in paragraph (f)(3)(ii)(A) of this section if the right or interest relates to property (other than a customer-related information base) described in paragraph (b)(4) or (5) of this section and the acquiring taxpayer establishes that—

(*1*) The transfer of the right or interest is not, under the principles of section 1235, a transfer of all substantial rights to such property or of an undivided interest in all substantial rights to such property; and

(*2*) The right or interest was transferred for an arm's-length consideration.

(iii) *Contracts for the use of section 197 intangibles; not acquired as part of a trade or business.* The transfer of a right or term interest described in paragraph (b)(11) of this section by the owner of the property to which such right or interest relates but not as part of a purchase of a trade or business will be closely scrutinized under the principles of section 1235 for purposes of determining whether the transfer is a sale or exchange and, accordingly, whether amounts paid on account of the transfer are chargeable to capital account. If under the principles of section 1235 the transaction is not a sale or exchange, amounts paid on account of the transfer are not chargeable to capital account under this paragraph (f)(3).

(iv) *Applicable rules*—(A) *Franchises, trademarks, and trade names.* For purposes of this paragraph (f)(3), section 197 intangibles described in paragraph (b)(11) of this section do not include any property that is also described in paragraph (b)(10) of this section (relating to franchises, trademarks, and trade names).

(B) *Certain amounts treated as payable under a debt instrument*—(*1*) *In general.* For purposes of applying any provision of the Internal Revenue Code to a person making payments of amounts that are otherwise chargeable to capital account under this paragraph (f)(3) and are payable after the acquisition of the section 197 intangible to which they relate, such amounts are treated as payable under a debt instrument given in consideration for the sale or exchange of the section 197 intangible.

(*2*) *Rights granted by governmental units.* For purposes of applying any provision of the Internal Revenue Code to any amounts that are otherwise chargeable to capital account with respect to a license, permit, or other right described in paragraph (b)(8) of this section (relating to rights granted by a governmental unit or agency or instrumentality thereof) and are payable after the acquisition of the section 197 intangible to which they relate, such amounts are treated, except as provided in paragraph (f)(4)(i) of this section (relating to renewal transactions), as payable under a debt instrument given in consideration for the sale or exchange of the section 197 intangible.

(*3*) *Treatment of other parties to transaction.* No person shall be treated as having sold, exchanged, or otherwise disposed of property in a transaction for purposes of any provision of the Internal Revenue Code solely by reason of the application of this paragraph (f)(3) to any other party to the transaction.

(*4*) *Basis determinations in certain transactions*—(*i*) *Certain renewal transactions.* The costs paid or incurred for the renewal of a franchise, trademark, or trade name or any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof are amortized over the 15-year period that begins with the month of renewal. Any costs paid or incurred for the issuance, or earlier renewal, continue to be taken into account over the remaining portion of the amortization period that began at the time of the issuance, or earlier renewal. Any amount paid or incurred for the protection, expansion, or defense of a trademark or trade name and chargeable to capital account is treated as an amount paid or incurred for a renewal.

(*ii*) *Transactions subject to section 338 or 1060.* In the case of a section 197 intangible deemed to have been acquired as the result of a qualified stock purchase within the meaning of section 338(d)(3), the basis shall be determined pursuant to section 338(b)(5) and the regulations thereunder. In the case of a section 197 intangible acquired in an applicable asset acquisition within the meaning of section 1060(c), the basis shall be determined pursuant to section 1060(a) and the regulations thereunder.

(*iii*) *Certain reinsurance transactions.* See paragraph (g)(5)(ii) of this section for special rules regarding the adjusted basis of an insurance contract acquired through an assumption reinsurance transaction.

(g) *Special rules*—(1) *Treatment of certain dispositions*—(i) *Loss disallowance rules*—(A) *In general.* No loss is recognized on the disposition of an amortizable section 197 intangible if the taxpayer has any retained intangibles. The retained intangibles with respect to the disposition of any amortizable section 197 intangible (the transferred intangible) are all amortizable section 197 intangibles, or rights to use or interests (including beneficial or other indirect interests) in amortizable section 197 intangibles (including the transferred intangible) that were acquired in the same transaction or series of related transactions as the transferred intangible and are retained after its disposition. Except as otherwise provided in paragraph (g)(1)(iv)(B) of this section, the adjusted basis of each of the retained intangibles is increased by the product of—

(*1*) The loss that is not recognized solely by reason of this rule; and

(*2*) A fraction, the numerator of which is the adjusted basis of the retained intangible on the date of the disposition and the denominator of which is the total adjusted bases of all the retained intangibles on that date.

(B) *Abandonment or worthlessness.* The abandonment of an amortizable section 197 intangible, or any other event rendering an amortizable section 197 intangible worthless, is treated as a disposition of the intangible for purposes of this paragraph (g)(1), and the abandoned or worthless intangible is disregarded (that is, it is not treated as a retained intangible) for purposes of applying this paragraph (g)(1) to the subsequent disposition of any other amortizable section 197 intangible.

(C) *Certain nonrecognition transfers.* The loss disallowance rule in paragraph (g)(1)(i)(A) of this section also applies when a taxpayer transfers an amortizable section 197 intangible from an acquired trade or business in a transaction in which the intangible is transferred basis property and, after the transfer, retains other amortizable section 197 intangibles from the trade or business. Thus, for example, the transfer of an amortizable section 197 intangible to a corporation in exchange for stock in the corporation in a transaction described in section 351, or to a partnership in exchange for an interest in the partnership in a transaction described in section 721, when other amortizable section 197 intangibles acquired in the same transaction are retained, followed by a sale of the stock or partnership interest received, will not avoid the application of the loss disallowance provision to the extent the adjusted basis of the transferred intangible at the time of the sale exceeds its fair market value at that time.

(ii) *Separately acquired property.* Paragraph (g)(1)(i) of this section does not apply to an amortizable section 197 intangible that is not acquired in a transaction or series of related transactions in which the taxpayer acquires other amortizable section 197 intangibles (a separately acquired intangible). Consequently, a loss may be recognized upon the disposition of a separately acquired amortizable section 197 intangible. However, the termination or worthlessness of only a portion of an amortizable section 197 intangible is not the disposition of a separately acquired intangible. For example, neither the loss of several customers from an acquired customer list nor the worthlessness of only some information from an acquired data base constitutes the disposition of a separately acquired intangible.

(iii) *Disposition of a covenant not to compete.* If a covenant not to compete or any other arrangement having substantially the same effect is entered into in connection with the direct or indirect acquisition of an interest in one or more trades or businesses, the disposition or worthlessness of the covenant or other arrangement will not be considered to occur until the disposition or worthlessness of all interests in those trades or businesses. For example, a covenant not to compete entered into in connection with the purchase of stock continues to be amortized ratably over the 15-year recovery period (even after the covenant expires or becomes worthless) unless all the trades or businesses in which an interest was acquired through the stock purchase (or all the purchaser's interests in those trades or businesses) also are disposed of or become worthless.

(iv) *Taxpayers under common control*—(A) *In general.* Except as provided in paragraph (g)(1)(iv)(B) of this section, all persons that would be treated as a single taxpayer under section 41(f)(1) are treated as a single taxpayer under this paragraph (g)(1). Thus, for example, a loss is not recognized on the disposition of an amortizable section 197 intangible by a member of a controlled group of corporations (as defined in section 41(f)(5)) if, after the disposition, another member retains other amortizable section 197 intangibles acquired in the same transaction as the amortizable section 197 intangible that has been disposed of.

(B) *Treatment of disallowed loss.* If retained intangibles are held by a person other than the person incurring the disallowed loss, only the adjusted basis of intangibles retained by the person incurring the disallowed loss is increased, and only the adjusted basis of those intangibles is included in the denominator of the fraction described in paragraph (g)(1)(i)(A) of this section. If none of the retained intangibles are held by the person incurring the disallowed loss, the loss is allowed ratably, as a deduction under section 197, over the remainder of the period during which the intangible giving rise to the loss would have been amortizable, except that any remaining disallowed loss is allowed in full on the first date on which all other retained intangibles have been disposed of or become worthless.

(2) *Treatment of certain nonrecognition and exchange transactions*—(i) *Relationship to anti-churning rules.* This paragraph (g)(2) provides rules relating to the treatment of section 197 intangibles acquired in certain transactions. If these rules apply to a section 197(f)(9)

intangible (within the meaning of paragraph (h)(1)(i) of this section), the intangible is, notwithstanding its treatment under this paragraph (g)(2), treated as an amortizable section 197 intangible only to the extent permitted under paragraph (h) of this section.

(ii) *Treatment of nonrecognition and exchange transactions generally*—(A) *Transfer disregarded*. If a section 197 intangible is transferred in a transaction described in paragraph (g)(2)(ii)(C) of this section, the transfer is disregarded in determining—

(*1*) Whether, with respect to so much of the intangible's basis in the hands of the transferee as does not exceed its basis in the hands of the transferor, the intangible is an amortizable section 197 intangible; and

(*2*) The amount of the deduction under section 197 with respect to such basis.

(B) *Application of general rule*. If the intangible described in paragraph (g)(2)(ii)(A) of this section was an amortizable section 197 intangible in the hands of the transferor, the transferee will continue to amortize its adjusted basis, to the extent it does not exceed the transferor's adjusted basis, ratably over the remainder of the transferor's 15-year amortization period. If the intangible was not an amortizable section 197 intangible in the hands of the transferor, the transferee's adjusted basis, to the extent it does not exceed the transferor's adjusted basis, cannot be amortized under section 197. In either event, the intangible is treated, with respect to so much of its adjusted basis in the hands of the transferee as exceeds its adjusted basis in the hands of the transferor, in the same manner for purposes of section 197 as an intangible acquired from the transferor in a transaction that is not described in paragraph (g)(2)(ii)(C) of this section. The rules of this paragraph (g)(2)(ii) also apply to any subsequent transfers of the intangible in a transaction described in paragraph (g)(2)(ii)(C) of this section.

(C) *Transactions covered*. The transactions described in this paragraph (g)(2)(ii)(C) are—

(*1*) Any transaction described in section 332, 351, 361, 721, or 731; and

(*2*) Any transaction between corporations that are members of the same consolidated group immediately after the transaction.

(iii) *Certain exchanged-basis property*. This paragraph (g)(2)(iii) applies to property that is acquired in a transaction subject to section 1031 or 1033 and is permitted to be acquired without recognition of gain (replacement property). Replacement property is treated as if it were the property by reference to which its basis is determined (the predecessor property) in determining whether, with respect to so much of its basis as does not exceed the basis of the predecessor property, the replacement property is an amortizable section 197 intangible and the amortization period under section 197 with respect to such basis. Thus, if the predecessor property was an amortizable section 197 intangible, the taxpayer will amortize the adjusted basis of the replacement property, to the extent it does not exceed the adjusted basis of the predecessor property, ratably over the remainder of the 15-year amortization period for the predecessor property. If the predecessor property was not an amortizable section 197 intangible, the adjusted basis of the replacement property, to the extent it does not exceed the adjusted basis of the predecessor property, may not be amortized under section 197. In either event, the replacement property is treated, with respect to so much of its adjusted basis as exceeds the adjusted basis of the predecessor property, in the same manner for purposes of section 197 as property acquired from the transferor in a transaction that is not subject to section 1031 or 1033.

(iv) *Transfers under section 708(b)(1)*—(A) *In general*. Paragraph (g)(2)(ii) of this section applies to transfers of section 197 intangibles that occur or are deemed to occur by reason of the termination of a partnership under section 708(b)(1).

(B) *Termination by sale or exchange of interest*. In applying paragraph (g)(2)(ii) of this section to a partnership that is terminated pursuant to section 708(b)(1)(B) (relating to deemed terminations from the sale or exchange of an interest), the terminated partnership is treated as the transferor and the new partnership is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination. (See paragraph (g)(3) of this section for the treatment of increases in the bases of property of the terminated partnership under section 743(b).)

(C) *Other terminations*. In applying paragraph (g)(2)(ii) of this section to a partnership that is terminated pursuant to section 708(b)(1)(A) (relating to cessation of activities by a partnership), the terminated partnership is treated as the transferor and the distributee partner is treated as the transferee with respect to any section 197 intangible held by the terminated partnership immediately preceding the termination.

(3) *Increase in the basis of partnership property under section 732(b), 734(b), 743(b), or 732(d)*. Any increase in the adjusted basis of a section 197 intangible under sections 732(b) or 732(d) (relating to a partner's basis in property distributed by a partnership), section 734(b) (relating to the optional adjustment to the basis of undistributed partnership property after a distribution of property to a partner), or section 743(b) (relating to the optional adjustment to the basis of partnership property after transfer of a partnership interest) is treated as a separate section 197 intangible. For purposes of determining the amortization period under section 197 with respect to the basis increase, the intangible is treated as having been acquired at the time of the transaction that causes the basis increase, except as provided in §1.743–1(j)(4)(i)(B)(*2*). The provisions of paragraph (f)(2) of this section apply to the extent that the amount of the basis increase is determined by reference to contingent payments. For purposes of the effective date and anti-churning provisions (paragraphs (l)(1) and (h) of this section) for a basis increase under section 732(d), the intangible is treated as having been acquired by the transferee partner at the time of the transfer of the partnership interest described in section 732(d).

(4) *Section 704(c) allocations*—(i) *Allocations where the intangible is amortizable by the contributor*. To the extent that the intangible was an amortizable section 197 intangible in the hands of the contributing partner, a partnership may make allocations of amortization deductions with respect to the intangible to all of its partners under any of the permissible methods described in the regulations under section 704(c). See §1.704–3.

(ii) *Allocations where the intangible is not amortizable by the contributor*. To the extent that the intangible was not an amortizable section 197 intangible in the hands of the contributing partner, the intangible is not amortizable under section 197 by the partnership. However, if a partner contributes a section 197 intangible to a partnership and the partnership adopts the remedial allocation method for making section 704(c) allocations of amortization deductions, the partnership generally may make remedial allocations of amortization deductions with respect to the contributed section 197 intangible in accordance with §1.704–3(d). See paragraph (h)(12) of this section to determine the application of the anti-churning rules in the context of remedial allocations.

(5) *Treatment of certain insurance contracts acquired in an assumption reinsurance transaction*—(i) *In general*. Section 197 generally applies to insurance and annuity contracts acquired from another person through an assumption reinsurance transaction. *See* §1.809–5(a)(7)(ii) for the definition of assumption reinsurance. The transfer of insurance or annuity contracts and the assumption of related liabilities deemed to occur by reason of a section 338 election for a target insurance company is treated as an assumption reinsurance transaction. The transfer of a reinsurance contract by a reinsurer (transferor) to another reinsurer (acquirer) is treated as an assumption reinsurance transaction if the transferor's obligations are extinguished as a result of the transaction.

(ii) *Determination of adjusted basis of amortizable section 197 intangible resulting from an assumption reinsurance transaction*—(A) *In general*. Section 197(f)(5) determines the basis of an amortizable section 197 intangible for insurance or annuity contracts acquired in an assumption reinsurance transaction. The basis of such intangible is the excess, if any, of—

(*1*) The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction; over

(*2*) The amount, if any, required to be capitalized under section 848 in connection with such transaction.

(B) *Amount paid or incurred by acquirer (reinsurer) under the assumption reinsurance transaction.* The amount paid or incurred by the acquirer (reinsurer) under the assumption reinsurance transaction is—

(*1*) In a deemed asset sale resulting from an election under section 338, the amount of the adjusted grossed-up basis (AGUB) allocable thereto (see §§1.338–6 and 1.338–11(b)(2));

(*2*) In an applicable asset acquisition within the meaning of section 1060, the amount of the consideration allocable thereto (see §§1.338–6, 1.338–11(b)(2), and 1.1060–1(c)(5)); and

(*3*) In any other transaction, the excess of the increase in the reinsurer's tax reserves resulting from the transaction (computed in accordance with sections 807, 832(b)(4)(B), and 846) over the value of the net assets received from the ceding company in the transaction.

(C) *Amount required to be capitalized under section 848 in connection with the transaction*—(1) *In general.* The amount required to be capitalized under section 848 for specified insurance contracts (as defined in section 848(e)) acquired in an assumption reinsurance transaction is the lesser of—

(*i*) The reinsurer's required capitalization amount for the assumption reinsurance transaction; or

(*ii*) The reinsurer's general deductions (as defined in section 848(c)(2)) allocable to the transaction.

(2) *Required capitalization amount.* The reinsurer determines the required capitalization amount for an assumption reinsurance transaction by multiplying the net positive or net negative consideration for the transaction by the applicable percentage set forth in section 848(c)(1) for the category of specified insurance contracts acquired in the transaction. See §1.848–2(g)(5). If more than one category of specified insurance contracts is acquired in an assumption reinsurance transaction, the required capitalization amount for each category is determined as if the transfer of the contracts in that category were made under a separate assumption reinsurance transaction. See §1.848–2(f)(7).

(*3*) *General deductions allocable to the assumption reinsurance transaction.* The reinsurer determines the general deductions allocable to the assumption reinsurance transaction in accordance with the procedure set forth in §1.848–2(g)(6). Accordingly, the reinsurer must allocate its general deductions to the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly before determining the general deductions allocable to the assumption reinsurance transaction. For purposes of allocating its general deductions under §1.848–2(g)(6), the reinsurer includes premiums received on the acquired specified insurance contracts after the assumption reinsurance transaction in determining the amount required under section 848(c)(1) on specified insurance contracts that the reinsurer has issued directly. If the reinsurer has entered into multiple reinsurance agreements during the taxable year, the reinsurer determines the general deductions allocable to each reinsurance agreement (including the assumption reinsurance transaction) by allocating the general deductions allocable to reinsurance agreements under §1.848–2(g)(6) to each reinsurance agreement with a positive required capitalization amount.

(*4*) *Treatment of a capitalization shortfall allocable to the reinsurance agreement*—(i) *In general.* The reinsurer determines any capitalization shortfall allocable to the assumption reinsurance transaction in the manner provided in §§1.848–2(g)(4) and 1.848–2(g)(7). If the reinsurer has a capitalization shortfall allocable to the assumption reinsurance transaction, the ceding company must reduce the net negative consideration (as determined under §1.848–2(f)(2)) for the transaction by the amount described in §1.848–2(g)(3) unless the parties make the election provided in §1.848–2(g)(8) to determine the amounts capitalized under section 848 in connection with the transaction without regard to the general deductions limitation of section 848(c)(2).

(*ii*) *Treatment of additional capitalized amounts as the result of an election under §1.848–2(g)(8).* The additional amounts capitalized by the reinsurer as the result of the election under §1.848–2(g)(8) reduce the adjusted basis of any amortizable section 197 intangible with respect to specified insurance contracts acquired in the assumption reinsurance transaction. If the additional capitalized amounts exceed the adjusted basis of the amortizable section 197 intangible, the reinsurer must reduce its deductions under section 805 or section 832 by the amount of such excess. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to the premiums and other consideration on the assumption reinsurance transaction and are deducted ratably over a 120-month period as provided under section 848(a)(2).

(*5*) *Cross references and special rules.* In general, for rules applicable to the determination of specified policy acquisition expenses, net premiums, and net consideration, see section 848(c) and (d), and §1.848–2(a) and (f). However, the following special rules apply for purposes of this paragraph (g)(5)(ii)(C)—

(*i*) The amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction cannot be less than zero;

(*ii*) For purposes of determining the company's general deductions under section 848(c)(2) for the taxable year of the assumption reinsurance transaction, the reinsurer takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred by the reinsurer for the specified insurance contracts were allocated to an amortizable section 197 intangible with respect to insurance contracts acquired in an assumption reinsurance transaction; and

(*iii*) Any reduction of specified policy acquisition expenses pursuant to an election under §1.848–2(i)(4) (relating to an assumption reinsurance transaction with an insolvent insurance company) is disregarded.

(D) *Examples.* The following examples illustrate the principles of this paragraph (g)(5)(ii):

Example 1. (i) *Facts.* On January 15, 2006, P acquires all of the stock of T, an insurance company, in a qualified stock purchase and makes a section 338 election for T. T issues individual life insurance contracts which are specified insurance contracts as defined in section 848(e)(1). P and new T are calendar year taxpayers. Under §§1.338–6 and 1.338–11(b)(2), the amount of AGUB allocated to old T's individual life insurance contracts is $300,000. On the acquisition date, the tax reserves for old T's individual life insurance contracts are $2,000,000. After the acquisition date, new T receives $1,000,000 of net premiums with respect to new and renewal individual life insurance contracts and incurs $100,000 of general deductions under section 848(c)(2) through December 31, 2006. New T engages in no other reinsurance transactions other than the assumption reinsurance transaction treated as occurring by reason of the section 338 election.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction. New T determines the adjusted basis under section 197(f)(5) for the life insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the individual life insurance contracts is $300,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is $130,900, which is determined by multiplying the $1,700,000 net positive consideration for the transaction ($2,000,000 reinsurance premium less $300,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired individual life insurance contracts (7.7 percent). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's individual life insurance contracts ($300,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of $120,000 ($100,000 + $300,000/15). Under §1.848–2(g)(6), these general deductions are first allocated to the $77,000 capitalization requirement for new T's directly written business ($1,000,000 × .077). Thus, $43,000 ($120,000 −

$77,000) of the general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction ($43,000) are less than the required capitalization amount for the transaction ($130,900), new T has a capitalization shortfall of $87,900 ($130,900 − $43,000) with regard to the transaction. Under §1.848–2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by $1,141,558 ($87,900 ÷ .077) unless the parties make the election under §1.848–2(g)(8) to capitalize specified policy acquisition expenses in connection with the assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would be $130,900. The $130,900 capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the specified insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T would have an adjusted basis under section 197(f)(5) with respect to the individual life insurance contracts acquired from old T of $169,100 ($300,000 − $130,900). New T's actual amortization deduction under section 197(a) with respect to the amortizable section 197 intangible for insurance contracts acquired in the assumption reinsurance transaction would be $11,273 ($169,100 ÷ 15).

Example 2. (i) *Facts.* The facts are the same as *Example 1*, except that T only issues accident and health insurance contracts that are qualified long-term care contracts under section 7702B. Under section 7702B(a)(5), T's qualified long-term care insurance contracts are treated as guaranteed renewable accident and health insurance contracts, and, therefore, are considered specified insurance contracts under section 848(e)(1). Under §§1.338–6 and 1.338–11(b)(2), the amount of AGUB allocable to T's qualified long-term care insurance contracts is $250,000. The amount of T's tax reserves for the qualified long-term care contracts on the acquisition date is $7,750,000. Following the acquisition, new T receives net premiums of $500,000 with respect to qualified long-term care contracts and incurs general deductions of $75,000 through December 31, 2006.

(ii) *Analysis.* The transfer of insurance contracts and the assumption of related liabilities deemed to occur by reason of the election under section 338 is treated as an assumption reinsurance transaction. New T determines the adjusted basis under section 197(f)(5) for the insurance contracts acquired in the assumption reinsurance transaction as follows. The amount paid or incurred for the insurance contracts is $250,000. To determine the amount required to be capitalized under section 848 in connection with the assumption reinsurance transaction, new T compares the required capitalization amount for the assumption reinsurance transaction with the general deductions allocable to the transaction. The required capitalization amount for the assumption reinsurance transaction is $577,500, which is determined by multiplying the $7,500,000 net positive consideration for the transaction ($7,750,000 reinsurance premium less $250,000 ceding commission) by the applicable percentage under section 848(c)(1) for the acquired insurance contracts (7.7 percent). To determine its general deductions, new T takes into account a tentative amortization deduction under section 197(a) as if the entire amount paid or incurred for old T's insurance contracts ($250,000) were allocable to an amortizable section 197 intangible with respect to insurance contracts acquired in the assumption reinsurance transaction. Accordingly, for the year of the assumption reinsurance transaction, new T is treated as having general deductions under section 848(c)(2) of $91,667 ($75,000 + $250,000 / 15). Under §1.848–2(g)(6), these general deductions are first allocated to the $38,500 capitalization requirement for new T's directly written business ($500,000 × .077). Thus, $53,167 ($91,667 − $38,500) of general deductions are allocable to the assumption reinsurance transaction. Because the general deductions allocable to the assumption reinsurance transaction ($53,167) are less than the required capitalization amount for the transaction ($577,500), new T has a capitalization shortfall of $524,333 ($577,500 − $53,167) with regard to the transaction. Under §1.848–2(g), this capitalization shortfall would cause old T to reduce the net negative consideration taken into account with respect to the assumption reinsurance transaction by $6,809,519 ($524,333 ÷ .077) unless the parties make the election under §1.848–2(g)(8) to capitalize specified policy acquisition expenses in connection with the assumption reinsurance transaction without regard to the general deductions limitation. If the parties make the election, the amount capitalized by new T under section 848 in connection with the assumption reinsurance transaction would increase from $53,167 to $577,500. Pursuant to paragraph (g)(5)(ii)(C)(*4*) of this section, the additional $524,333 ($577,500 − $53,167) capitalized by new T under section 848 would reduce new T's adjusted basis of the amortizable section 197 intangible with respect to the insurance contracts acquired in the assumption reinsurance transaction. Accordingly, new T's adjusted basis of the section 197 intangible with regard to the insurance contracts is reduced from $196,833 ($250,000 − $53,167) to $0. Because the additional $524,333 capitalized pursuant to the §1.848–2(g)(8) election exceeds the $196,833 adjusted basis of the section 197 intangible before the reduction, new T is required to reduce its deductions under section 805 by the $327,500 ($524,333 – $196,833).

(E) *Effective/applicability date.* This section applies to acquisitions and dispositions of insurance contracts on or after April 10, 2006.

(iii) *Application of loss disallowance rule upon a disposition of an insurance contract acquired in an assumption reinsurance transaction.* The following rules apply for purposes of applying the loss disallowance rules of section 197(f)(1)(A) to the disposition of a section 197(f)(5) intangible. For this purpose, a section 197(f)(5) intangible is an amortizable section 197 intangible the basis of which is determined under section 197(f)(5).

(A) *Disposition*—(*1*) *In general.* A disposition of a section 197 intangible is any event as a result of which, absent section 197, recovery of basis is otherwise allowed for Federal income tax purposes.

(*2*) *Treatment of indemnity reinsurance transactions.* The transfer through indemnity reinsurance of the right to the future income from the insurance contracts to which a section 197(f)(5) intangible relates does not preclude the recovery of basis by the ceding company, provided that sufficient economic rights relating to the reinsured contracts are transferred to the reinsurer. However, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if it has a right to experience refunds reflecting a significant portion of the future profits on the reinsured contracts, or if it retains an option to reacquire a significant portion of the future profits on the reinsured contracts through the exercise of a recapture provision. In addition, the ceding company is not permitted to recover basis in an indemnity reinsurance transaction if the reinsurer assumes only a limited portion of the ceding company's risk relating to the reinsured contracts (excess loss reinsurance).

(B) *Loss.* The loss, if any, recognized by a taxpayer on the disposition of a section 197(f)(5) intangible equals the amount by which the taxpayer's adjusted basis in the section 197(f)(5) intangible immediately before the disposition exceeds the amount, if any, that the taxpayer receives from another person for the future income right from the insurance contracts to which the section 197(f)(5) intangible relates. In determining the amount of the taxpayer's loss on the disposition of a section 197(f)(5) intangible through a reinsurance transaction, any effect of the transaction on the amounts capitalized by the taxpayer as specified policy acquisition expenses under section 848 is disregarded.

(C) *Examples.* The following examples illustrate the principles of this paragraph (g)(5)(iii):

Example 1. (i) *Facts.* In a prior taxable year, as a result of a section 338 election with respect to T, new T was treated as purchasing all of old T's insurance contracts that were in force on the acquisition date in an assumption reinsurance transaction. Under §§1.338–6 and 1.338–11(b)(2), the amount of AGUB allocable to the future income right from the purchased insurance contracts was $15, net of the amounts required to be capitalized under section 848 as a result of the assumption reinsurance transaction. At the beginning of the current taxable year, as a result of amortization deductions allowed by section 197(a), new T's adjusted basis in the section 197(f)(5) intangible resulting from the assumption reinsurance transaction is $12. During the current taxable year, new T enters into an indemnity reinsurance agreement with R, another insurance company, in which R assumes 100 percent of the risk relating to the insurance contracts to which the section 197(f)(5) intangible relates. In the indemnity reinsurance transaction, R agrees to pay new T a ceding commission of $10 in exchange for the future profits on the underlying reinsured policies. Under the indemnity reinsurance agreement, new T continues to administer the reinsured policies, but transfers investment assets equal to the required reserves for the reinsured policies together with all future premiums to R. The indemnity reinsurance agreement does not contain an experience refund provision or a provision allowing new T to terminate the reinsurance agreement at its sole option. New T retains the insurance licenses and other amortizable section 197 intangibles acquired in the deemed asset sale and continues to underwrite and issue new insurance contracts.

(ii) *Analysis.* The indemnity reinsurance agreement constitutes a disposition of the section 197(f)(5) intangible because it involves the transfer of sufficient economic rights attributable to the insurance contracts to which the section 197(f)(5) intangible relates such that recovery of basis is allowed. For purposes of applying the loss disallowance rules of section 197(f)(1) and paragraph (g) of this section, new T's loss is $2 (new T's adjusted basis in the section 197(f)(5) intangible immediately before the disposition ($12) less the ceding commission ($10)). Therefore, new T applies $10 of the adjusted basis in the section 197(f)(5) intangible against the amount received from R for the future income right on the reinsured policies and increases its basis in the amortizable section 197 intangibles that it acquired and retained from the deemed asset sale by $2, the amount of the disallowed loss. The amount of new T's disallowed loss under section 197(f)(1)(A) is determined without regard to the effect of the indemnity reinsurance transaction on the amounts capitalized by new T as specified policy acquisition expenses under section 848.

Example 2. (i) *Facts.* Assume the same facts as in *Example 1,* except that under the indemnity reinsurance agreement R agrees to pay new T a ceding commission of $5 with respect to the underlying reinsured contracts. In addition, under the indemnity reinsurance agreement, new T is entitled to an experience refund equal to any future profits on the reinsured contracts in excess of the ceding commission plus an annual risk charge. New T also has a right to recapture the business at any time after R has recovered an amount equal to the ceding commission.

(ii) *Analysis.* The indemnity reinsurance agreement between new T and R does not represent a disposition because it does not involve the transfer of sufficient economic rights with respect to the future income on the reinsured contracts. Therefore, new T may not recover its basis in the section 197(f)(5) intangible to which the contracts relate and must continue to amortize ratably the adjusted basis of the section 197(f)(5) intangible over the remainder of the 15-year recovery period and cannot apply any portion of this adjusted basis to offset the ceding commission received from R in the indemnity reinsurance transaction.

(iv) *Effective dates*—(A) *In general*—This paragraph (g)(5) applies to acquisitions and dispositions on or after April 10, 2006. For rules applicable to acquisitions and dispositions before that date, see §1.197–2 in effect before that date (*see* 26 CFR part 1, revised April 1, 2001).

(B) *Application to pre-effective date acquisitions and dispositions.* A taxpayer may choose, on a transaction-by-transaction basis, to apply the provisions of this paragraph (g)(5) to property acquired and disposed of before April 10, 2006.

(C) *Change in method of accounting*—(*1*) *In general*—A change in a taxpayer's treatment of all property acquired and disposed under paragraph (g)(5) is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply.

(*2*) *Acquisitions and dispositions on or after effective date.* A Taxpayer is granted the consent of the Commissioner under section 446(e) to change its method of accounting to comply with this paragraph (g)(5) for acquisitions and dispositions on or after April 10, 2006. The change must be made on a cut-off basis with no section 481(a) adjustment. Notwithstanding §1.446–1(e)(3), a taxpayer should not file a Form 3115, ''Application for Change in Accounting Method,'' to obtain the consent of the Commissioner to change its method of accounting under this paragraph (g)(5)(iv)(C)(*2*). Instead, a taxpayer must make the change by using the new method on its federal income tax returns.

(*3*) *Acquisitions and dispositions before the effective date.* For the first taxable year ending after April 10, 2006, a taxpayer is granted consent of the Commissioner to change its method of accounting for all property acquired in transactions described in paragraph (g)(5)(iv)(B) to comply with this paragraph (g)(5) unless the proper treatment of any such property is an issue under consideration in an examination, before an Appeals office, or before a Federal Court. (For the definition of when an issue is under consideration, see, Rev. Proc. 97–27 (1997–1 C.B. 680); and, §601.601(d)(2) of this chapter). A taxpayer changing its method of accounting in accordance with this paragraph (g)(5)(iv)(C)(*3*) must follow the applicable administrative procedures for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see, for example, Rev. Proc. 2002–9 (2002–1 C.B. 327) as modified and clarified by Announcement 2002–17 (2002–1 C.B. 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 C.B. 696), and amplified, clarified and modified by Rev. Proc. 2002–54 (2002–2 C.B. 432); and,

§ 601.601(d)(2) of this chapter), except, for purposes of this paragraph (g)(5)(iv)(C)(*3*), any limitations in such administrative procedures for obtaining the automatic consent of the Commissioner shall not apply. However, if the taxpayer is under examination, before an appeals office, or before a Federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the National Office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate. For purposes of From 3115, ''Application for Change in Accounting Method,'' the designated number for the automatic accounting method change authorized by this paragraph (g)(5)(iv)(C)(*3*) is ''98.'' A change in method of accounting in accordance with this paragraph (g)(5)(iv)(C)(*3*) requires an adjustment under section 481(a).

(6) *Amounts paid or incurred for a franchise, trademark, or trade name.* If an amount to which section 1253(d) (relating to the transfer, sale, or other disposition of a franchise, trademark, or trade name) applies is described in section 1253(d)(1)(B) (relating to contingent serial payments deductible under section 162), the amount is not included in the adjusted basis of the intangible for purposes of section 197. Any other amount, whether fixed or contingent, to which section 1253(d) applies is chargeable to capital account under section 1253(d)(2) and is amortizable only under section 197.

(7) *Amounts properly taken into account in determining the cost of property that is not a section 197 intangible.* Section 197 does not apply to an amount that is properly taken into account in determining the cost of property that is not a section 197 intangible. The entire cost of acquiring the other property is included in its basis and recovered under other applicable Internal Revenue Code provisions. Thus, for example, section 197 does not apply to the cost of an interest in computer software to the extent such cost is included, without being separately stated, in the cost of the hardware or other tangible property and is consistently treated as part of the cost of the hardware or other tangible property.

(8) *Treatment of amortizable section 197 intangibles as depreciable property.* An amortizable section 197 intangible is treated as property of a character subject to the allowance for depreciation under section 167. Thus, for example, an amortizable section 197 intangible is not a capital asset for purposes of section 1221, but if used in a trade or business and held for more than one year, gain or loss on its disposition generally qualifies as section 1231 gain or loss. Also, an amortizable section 197 intangible is section 1245 property and section 1239 applies to any gain recognized upon its sale or exchange between related persons (as defined in section 1239(b)).

(h) *Anti-churning rules*—(1) *Scope and purpose*—(i) *Scope.* This paragraph (h) applies to section 197(f)(9) intangibles. For this purpose, section 197(f)(9) intangibles are goodwill and going concern value that was held or used at any time during the transition period and any other section 197 intangible that was held or used at any time during the transition period and was not depreciable or amortizable under prior law.

(ii) *Purpose.* To qualify as an amortizable section 197 intangible, a section 197 intangible must be acquired after the applicable date (July 25, 1991, if the acquiring taxpayer has made a valid retroactive election pursuant to § 1.197–1T; August 10, 1993, in all other cases). The purpose of the anti-churning rules of section 197(f)(9) and this paragraph (h) is to prevent the amortization of section 197(f)(9) intangibles unless they are transferred after the applicable effective date in a transaction giving rise to a significant change in ownership or use. (Special rules apply for purposes of determining whether transactions involving partnerships give rise to a significant change in ownership or use. See paragraph (h)(12) of this section.) The anti-churning rules are to be applied in a manner that carries out their purpose.

(2) *Treatment of section 197(f)(9) intangibles.* Except as otherwise provided in this paragraph (h), a section 197(f)(9)

intangible acquired by a taxpayer after the applicable effective date does not qualify for amortization under section 197 if—

(i) The taxpayer or a related person held or used the intangible or an interest therein at any time during the transition period;

(ii) The taxpayer acquired the intangible from a person that held the intangible at any time during the transition period and, as part of the transaction, the user of the intangible does not change; or

(iii) The taxpayer grants the right to use the intangible to a person that held or used the intangible at any time during the transition period (or to a person related to that person), but only if the transaction in which the taxpayer grants the right and the transaction in which the taxpayer acquired the intangible are part of a series of related transactions.

(3) *Amounts deductible under section 1253(d) or §1.162–11.* For purposes of this paragraph (h), deductions allowable under section 1253(d)(2) or pursuant to an election under section 1253(d)(3) (in either case as in effect prior to the enactment of section 197) and deductions allowable under §1.162–11 are treated as deductions allowable for amortization under prior law.

(4) *Transition period.* For purposes of this paragraph (h), the transition period is July 25, 1991, if the acquiring taxpayer has made a valid retroactive election pursuant to §1.197–1T and the period beginning on July 25, 1991, and ending on August 10, 1993, in all other cases.

(5) *Exceptions.* The anti-churning rules of this paragraph (h) do not apply to—

(i) The acquisition of a section 197(f)(9) intangible if the acquiring taxpayer's basis in the intangible is determined under section 1014(a) or 1022; or

(ii) The acquisition of a section 197(f)(9) intangible that was an amortizable section 197 intangible in the hands of the seller (or transferor), but only if the acquisition transaction and the transaction in which the seller (or transferor) acquired the intangible or interest therein are not part of a series of related transactions.

(6) *Related person*—(i) *In general.* Except as otherwise provided in paragraph (h)(6)(ii) of this section, a person is related to another person for purposes of this paragraph (h) if—

(A) The person bears a relationship to that person that would be specified in section 267(b) (determined without regard to section 267(e)) and, by substitution, section 267(f)(1), if those sections were amended by substituting 20 percent for 50 percent; or

(B) The person bears a relationship to that person that would be specified in section 707(b)(1) if that section were amended by substituting 20 percent for 50 percent; or

(C) The persons are engaged in trades or businesses under common control (within the meaning of section 41(f)(1) (A) and (B)).

(ii) *Time for testing relationships.* Except as provided in paragraph (h)(6)(iii) of this section, a person is treated as related to another person for purposes of this paragraph (h) if the relationship exists—

(A) In the case of a single transaction, immediately before or immediately after the transaction in which the intangible is acquired; and

(B) In the case of a series of related transactions (or a series of transactions that together comprise a qualified stock purchase within the meaning of section 338(d)(3)), immediately before the earliest such transaction or immediately after the last such transaction.

(iii) *Certain relationships disregarded.* In applying the rules in paragraph (h)(7) of this section, if a person acquires an intangible in a series of related transactions in which the person acquires stock (meeting the requirements of section 1504(a)(2)) of a corporation in a fully taxable transaction followed by a liquidation of the acquired corporation under section 331, any relationship created as part of such series of transactions is disregarded in determining whether any person is related to such acquired corporation immediately after the last transaction.

(iv) *De minimis rule*—(A) *In general.* Two corporations are not treated as related persons for purposes of this paragraph (h) if—

(*1*) The corporations would (but for the application of this paragraph (h)(6)(iv)) be treated as related persons solely by reason of substituting ''more than 20 percent'' for ''more than 50 percent'' in section 267(f)(1)(A); and

(*2*) The beneficial ownership interest of each corporation in the stock of the other corporation represents less than 10 percent of the total combined voting power of all classes of stock entitled to vote and less than 10 percent of the total value of the shares of all classes of stock outstanding.

(B) *Determination of beneficial ownership interest.* For purposes of this paragraph (h)(6)(iv), the beneficial ownership interest of one corporation in the stock of another corporation is determined under the principles of section 318(a), except that—

(*1*) In applying section 318(a)(2)(C), the 50-percent limitation contained therein is not applied; and

(*2*) Section 318(a)(3)(C) is applied by substituting ''20 percent'' for ''50 percent''.

(7) *Special rules for entities that owned or used property at any time during the transition period and that are no longer in existence.* A corporation, partnership, or trust that owned or used a section 197 intangible at any time during the transition period and that is no longer in existence is deemed, for purposes of determining whether a taxpayer acquiring the intangible is related to such entity, to be in existence at the time of the acquisition.

(8) *Special rules for section 338 deemed acquisitions.* In the case of a qualified stock purchase that is treated as a deemed sale and purchase of assets pursuant to section 338, the corporation treated as purchasing assets as a result of an election thereunder (new target) is not considered the person that held or used the assets during any period in which the assets were held or used by the corporation treated as selling the assets (old target). Thus, for example, if a corporation (the purchasing corporation) makes a qualified stock purchase of the stock of another corporation after the transition period, new target will not be treated as the owner during the transition period of assets owned by old target during that period even if old target and new target are treated as the same corporation for certain other purposes of the Internal Revenue Code or old target and new target are the same corporation under the laws of the State or other jurisdiction of its organization. However, the anti-churning rules of this paragraph (h) may nevertheless apply to a deemed asset purchase resulting from a section 338 election if new target is related (within the meaning of paragraph (h)(6) of this section) to old target.

(9) *Gain-recognition exception*—(i) *Applicability.* A section 197(f)(9) intangible qualifies for the gain-recognition exception if—

(A) The taxpayer acquires the intangible from a person that would not be related to the taxpayer but for the substitution of 20 percent for 50 percent under paragraph (h)(6)(i)(A) of this section; and

(B) That person (whether or not otherwise subject to Federal income tax) elects to recognize gain on the disposition of the intangible and agrees, notwithstanding any other provision of law or treaty, to pay for the taxable year in which the disposition occurs an amount of tax on the gain that, when added to any other Federal income tax on such gain, equals the gain on the disposition multiplied by the highest marginal rate of tax for that taxable year.

(ii) *Effect of exception.* The anti-churning rules of this paragraph (h) apply to a section 197(f)(9) intangible that qualifies for the gain-recognition exception only to the extent the acquiring taxpayer's basis in the intangible exceeds the gain recognized by the transferor.

(iii) *Time and manner of election.* The election described in this paragraph (h)(9) must be made by the due date (including extensions of time) of the electing taxpayer's Federal income tax return for the taxable year in which the disposition occurs. The election is made by attaching an election statement satisfying the requirements of paragraph (h)(9)(viii) of this section to the electing taxpayer's original or amended income tax return for that taxable year (or by filing the statement as a return for the taxable year under paragraph (h)(9)(xi) of this section). In addition, the taxpayer must satisfy the notification requirements of paragraph (h)(9)(vi) of this section. The election is binding on the taxpayer and all parties whose Federal tax liability is affected by the election.

(iv) *Special rules for certain entities.* In the case of a partnership, S corporation, estate or trust, the election under this paragraph (h)(9) is made by the entity rather than by its owners or beneficiaries. If a partnership or S corporation makes an election under this paragraph (h)(9) with respect to the disposition of a section 197(f)(9) intangible, each of its partners or shareholders is required to pay a tax determined in the manner described in paragraph (h)(9)(i)(B) of this section on the amount of gain that is properly allocable to such partner or shareholder with respect to the disposition.

(v) *Effect of nonconforming elections.* An attempted election that does not substantially comply with each of the requirements of this paragraph (h)(9) is disregarded in determining whether a section 197(f)(9) intangible qualifies for the gain-recognition exception.

(vi) *Notification requirements.* A taxpayer making an election under this paragraph (h)(9) with respect to the disposition of a section 197(f)(9) intangible must provide written notification of the election on or before the due date of the return on which the election is made to the person acquiring the section 197 intangible. In addition, a partnership or S corporation making an election under this paragraph (h)(9) must attach to the Schedule K–1 furnished to each partner or shareholder a written statement containing all information necessary to determine the recipient's additional tax liability under this paragraph (h)(9).

(vii) *Revocation.* An election under this paragraph (h)(9) may be revoked only with the consent of the Commissioner.

(viii) *Election Statement.* An election statement satisfies the requirements of this paragraph (h)(9)(viii) if it is in writing and contains the information listed below. The required information should be arranged and identified in accordance with the following order and numbering system:

(A) The name and address of the electing taxpayer.

(B) Except in the case of a taxpayer that is not otherwise subject to Federal income tax, the taxpayer identification number (TIN) of the electing taxpayer.

(C) A statement that the taxpayer is making the election under section 197(f)(9)(B).

(D) Identification of the transaction and each person that is a party to the transaction or whose tax return is affected by the election (including, except in the case of persons not otherwise subject to Federal income tax, the TIN of each such person).

(E) The calculation of the gain realized, the applicable rate of tax, and the amount of the taxpayer's additional tax liability under this paragraph (h)(9).

(F) The signature of the taxpayer or an individual authorized to sign the taxpayer's Federal income tax return.

(ix) *Determination of highest marginal rate of tax and amount of other Federal income tax on gain*—(A) *Marginal rate.* The following rules apply for purposes of determining the highest marginal rate of tax applicable to an electing taxpayer:

(*1*) *Noncorporate taxpayers.* In the case of an individual, estate, or trust, the highest marginal rate of tax is the highest marginal rate of tax in effect under section 1, determined without regard to section 1(h).

(*2*) *Corporations and tax-exempt entities.* In the case of a corporation or an entity that is exempt from tax under section 501(a), the highest marginal rate of tax is the highest marginal rate of tax in effect under section 11, determined without regard to any rate that is added to the otherwise applicable rate in order to offset the effect of the graduated rate schedule.

(B) *Other Federal income tax on gain.* The amount of Federal income tax (other than the tax determined under this paragraph (h)(9)) imposed on any gain is the lesser of—

(*1*) The amount by which the taxpayer's Federal income tax liability (determined without regard to this paragraph (h)(9)) would be reduced if the amount of such gain were not taken into account; or

(*2*) The amount of the gain multiplied by the highest marginal rate of tax for the taxable year.

(x) *Coordination with other provisions*—(A) *In general.* The amount of gain subject to the tax determined under this paragraph (h)(9) is not reduced by any net operating loss deduction under section 172(a), any capital loss under section 1212, or any other similar loss or deduction. In addition, the amount of tax determined under this paragraph (h)(9) is not reduced by any credit of the taxpayer. In computing the amount of any net operating loss, capital loss, or other similar loss or deduction, or any credit that may be carried to any taxable year, any gain subject to the tax determined under this paragraph (h)(9) and any tax paid under this paragraph (h)(9) is not taken into account.

(B) *Section 1374.* No provision of paragraph (h)(9)(iv) of this section precludes the application of section 1374 (relating to a tax on certain built-in gains of S corporations) to any gain with respect to which an election under this paragraph (h)(9) is made. In addition, neither paragraph (h)(9)(iv) nor paragraph (h)(9)(x)(A) of this section precludes a taxpayer from applying the provisions of section 1366(f)(2) (relating to treatment of the tax imposed by section 1374 as a loss sustained by the S corporation) in determining the amount of tax payable under paragraph (h)(9) of this section.

(C) *Procedural and administrative provisions.* For purposes of subtitle F, the amount determined under this paragraph (h)(9) is treated as a tax imposed by section 1 or 11, as appropriate.

(D) *Installment method.* The gain subject to the tax determined under paragraph (h)(9)(i) of this section may not be reported under the method described in section 453(a). Any such gain that would, but for the application of this paragraph (h)(9)(x)(D), be taken into account under section 453(a) shall be taken into account in the same manner as if an election under section 453(d) (relating to the election not to apply section 453(a)) had been made.

(xi) *Special rules for persons not otherwise subject to Federal income tax.* If the person making the election under this paragraph (h)(9) with respect to a disposition is not otherwise subject to Federal income tax, the election statement satisfying the requirements of paragraph (h)(9)(viii) of this section must be filed with the Philadelphia Service Center. For purposes of this paragraph (h)(9) and subtitle F, the statement is treated as an income tax return for the calendar year in which the disposition occurs and as a return due on or before March 15 of the following year.

(10) *Transactions subject to both anti-churning and nonrecognition rules.* If a person acquires a section 197(f)(9) intangible in a transaction described in paragraph (g)(2) of this section from a person in whose hands the intangible was an amortizable section 197 intangible, and immediately after the transaction (or series of transactions described in paragraph (h)(6)(ii)(B) of this section) in which such intangible is acquired, the person acquiring the section 197(f)(9) intangible is related to any person described in paragraph (h)(2) of this section, the intangible is, notwithstanding its treatment under paragraph (g)(2) of this section, treated as an amortizable section 197 intangible only to the extent permitted under this paragraph (h). (See, for example, paragraph (h)(5)(ii) of this section.)

(11) *Avoidance purpose.* A section 197(f)(9) intangible acquired by a taxpayer after the applicable effective date does not qualify for amortization under section 197 if one of the principal purposes of the transaction in which it is acquired is to avoid the operation of the anti-churning rules of section 197(f)(9) and this paragraph (h). A transaction will be presumed to have a principal purpose of avoidance if it does not effect a significant change in the ownership or use of the intangible. Thus, for example, if section 197(f)(9) intangibles are acquired in a transaction (or series of related transactions) in which an option to acquire stock is issued to a party to the transaction, but the option is not treated as having been exercised for purposes of paragraph (h)(6) of this section, this paragraph (h)(11) may apply to the transaction.

(12) *Additional partnership anti-churning rules*—(i) *In general.* In determining whether the anti-churning rules of this

paragraph (h) apply to any increase in the basis of a section 197(f)(9) intangible under section 732(b), 732(d), 734(b), or 743(b), the determinations are made at the partner level and each partner is treated as having owned and used the partner's proportionate share of partnership property. In determining whether the anti-churning rules of this paragraph (h) apply to any transaction under another section of the Internal Revenue Code, the determinations are made at the partnership level, unless under §1.701–2(e) the Commissioner determines that the partner level is more appropriate.

(ii) *Section 732(b) adjustments*—(A) *In general*. The anti-churning rules of this paragraph (h) apply to any increase in the adjusted basis of a section 197(f)(9) intangible under section 732(b) to the extent that the basis increase exceeds the total unrealized appreciation from the intangible allocable to—

(*1*) Partners other than the distributee partner or persons related to the distributee partner;

(*2*) The distributee partner and persons related to the distributee partner if the distributed intangible is a section 197(f)(9) intangible acquired by the partnership on or before August 10, 1993, to the extent that—

(*i*) The distributee partner and related persons acquired an interest or interests in the partnership after August 10, 1993;

(*ii*) Such interest or interests were held after August 10, 1993, by a person or persons other than either the distributee partner or persons who were related to the distributee partner; and

(*iii*) The acquisition of such interest or interests by such person or persons was not part of a transaction or series of related transactions in which the distributee partner (or persons related to the distributee partner) subsequently acquired such interest or interests; and

(*3*) The distributee partner and persons related to the distributee partner if the distributed intangible is a section 197(f)(9) intangible acquired by the partnership after August 10, 1993, that is not amortizable with respect to the partnership, to the extent that—

(*i*) The distributee partner and persons related to the distributee partner acquired an interest or interests in the partnership after the partnership acquired the distributed intangible;

(*ii*) Such interest or interests were held after the partnership acquired the distributed intangible, by a person or persons other than either the distributee partner or persons who were related to the distributee partner; and

(*iii*) The acquisition of such interest or interests by such person or persons was not part of a transaction or series of related transactions in which the distributee partner (or persons related to the distributee partner) subsequently acquired such interest or interests.

(B) *Effect of retroactive elections*. For purposes of paragraph (h)(12)(ii)(A) of this section, references to August 10, 1993, are treated as references to July 25, 1991, if the relevant party made a valid retroactive election under §1.197–1T.

(C) *Intangible still subject to anti-churning rules*. Notwithstanding paragraph (h)(12)(ii) of this section, in applying the provisions of this paragraph (h) with respect to subsequent transfers, the distributed intangible remains subject to the provisions of this paragraph (h) in proportion to a fraction (determined at the time of the distribution), as follows—

(*1*) The numerator of which is equal to the sum of—

(*i*) The amount of the distributed intangible's basis that is nonamortizable under paragraph (g)(2)(ii)(B) of this section; and

(*ii*) The total unrealized appreciation inherent in the intangible reduced by the amount of the increase in the adjusted basis of the distributed intangible under section 732(b) to which the anti-churning rules do not apply; and

(*2*) The denominator of which is the fair market value of such intangible.

(D) *Partner's allocable share of unrealized appreciation from the intangible*. The amount of unrealized appreciation from an intangible that is allocable to a partner is the amount of taxable gain that would have been allocated to that partner if the partnership had sold the intangible immediately before the distribution for its fair market value in a fully taxable transaction.

(E) *Acquisition of partnership interest by contribution.* Solely for purposes of paragraphs (h)(12)(ii)(A)(*2*) and (*3*) of this section, a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of the contribution based on each partner's respective proportionate interest in the partnership.

(iii) *Section 732(d) adjustments.* The anti-churning rules of this paragraph (h) do not apply to an increase in the basis of a section 197(f)(9) intangible under section 732(d) if, had an election been in effect under section 754 at the time of the transfer of the partnership interest, the distributee partner would have been able to amortize the basis adjustment made pursuant to section 743(b).

(iv) *Section 734(b) adjustments*—(A) *In general.* The anti-churning rules of this paragraph (h) do not apply to a continuing partner's share of an increase in the basis of a section 197(f)(9) intangible held by a partnership under section 734(b) to the extent that the continuing partner is an eligible partner.

(B) *Eligible partner.* For purposes of this paragraph (h)(12)(iv), eligible partner means—

(*1*) A continuing partner that is not the distributee partner or a person related to the distributee partner;

(*2*) A continuing partner that is the distributee partner or a person related to the distributee partner, with respect to any section 197(f)(9) intangible acquired by the partnership on or before August 10, 1993, to the extent that—

(*i*) The distributee partner's interest in the partnership was acquired after August 10, 1993;

(*ii*) Such interest was held after August 10, 1993 by a person or persons who were not related to the distributee partner; and

(*iii*) The acquisition of such interest by such person or persons was not part of a transaction or series of related transactions in which the distributee partner or persons related to the distributee partner subsequently acquired such interest; or

(*3*) A continuing partner that is the distributee partner or a person related to the distributee partner, with respect to any section 197(f)(9) intangible acquired by the partnership after August 10, 1993, that is not amortizable with respect to the partnership, to the extent that—

(*i*) The distributee partner's interest in the partnership was acquired after the partnership acquired the relevant intangible;

(*ii*) Such interest was held after the partnership acquired the relevant intangible by a person or persons who were not related to the distributee partner; and

(*iii*) The acquisition of such interest by such person or persons was not part of a transaction or series of related transactions in which the distributee partner or persons related to the distributee partner subsequently acquired such interest.

(C) *Effect of retroactive elections.* For purposes of paragraph (h)(12)(iv)(A) of this section, references to August 10, 1993, are treated as references to July 25, 1991, if the distributee partner made a valid retroactive election under §1.197–1T.

(D) *Partner's share of basis increase*—(*1*) In general. Except as provided in paragraph (h)(12)(iv)(D)(*2*) of this section, for purposes of this paragraph (h)(12)(iv), a continuing partner's share of a basis increase under section 734(b) is equal to—

(*i*) The total basis increase allocable to the intangible; multiplied by

(*ii*) A fraction the numerator of which is the amount of the continuing partner's post-distribution capital account (determined immediately after the distribution in accordance with the capital accounting rules of §1.704–1(b)(2)(iv)), and the denominator of which is the total amount of the post-distribution capital accounts (determined immediately after the distribution in accordance with the capital accounting rules of §1.704–1(b)(2)(iv)) of all continuing partners.

(*2*) *Exception where partnership does not maintain capital accounts.* If a partnership does not maintain capital accounts in accordance with §1.704–1(b)(2)(iv), then for purposes of this paragraph (h)(12)(iv), a continuing partner's share of a basis increase is equal to—

(*i*) The total basis increase allocable to the intangible; multiplied by

(*ii*) The partner's overall interest in the partnership as determined under §1.704–1(b)(3) immediately after the distribution.

(E) *Interests acquired by contribution*—(*1*) *Application of paragraphs (h)(12)(iv)(B) (2) and (3) of this section.* Solely for purposes of paragraphs (h)(12)(iv)(B)(*2*) and (*3*) of this section, a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of the contribution based on each such partner's proportionate interest in the partnership.

(*2*) *Special rule with respect to paragraph (h)(12)(iv)(B)(1) of this section.* Solely for purposes of paragraph (h)(12)(iv)(B)(*1*) of this section, if a distribution that gives rise to an increase in the basis under section 734(b) of a section 197(f)(9) intangible held by the partnership is undertaken as part of a series of related transactions that include a contribution of the intangible to the partnership by a continuing partner, the continuing partner is treated as related to the distributee partner in analyzing the basis adjustment with respect to the contributed section 197(f)(9) intangible.

(F) *Effect of section 734(b) adjustments on partners' capital accounts.* If one or more partners are subject to the anti-churning rules under this paragraph (h) with respect to a section 734(b) adjustment allocable to an intangible asset, taxpayers may use any reasonable method to determine amortization of the asset for book purposes, provided that the method used does not contravene the purposes of the anti-churning rules under section 197 and this paragraph (h). A method will be considered to contravene the purposes of the anti-churning rules if the effect of the book adjustments resulting from the method is such that any portion of the tax deduction for amortization attributable to the section 734 adjustment is allocated, directly or indirectly, to a partner who is subject to the anti-churning rules with respect to such adjustment.

(v) *Section 743(b) adjustments*—(A) *General rule.* The anti-churning rules of this paragraph (h) do not apply to an increase in the basis of a section 197 intangible under section 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest. In addition, the anti-churning rules of this paragraph (h) do not apply to an increase in the basis of a section 197 intangible under section 743(b) to the extent that—

(*1*) The partnership interest being transferred was acquired after August 10, 1993, provided—

(*i*) The section 197(f)(9) intangible was acquired by the partnership on or before August 10, 1993;

(*ii*) The partnership interest being transferred was held after August 10, 1993, by a person or persons (the post-1993 person or persons) other than the person transferring the partnership interest or persons who were related to the person transferring the partnership interest; and

(*iii*) The acquisition of such interest by the post-1993 person or persons was not part of a transaction or series of related transactions in which the person transferring the partnership interest or persons related to the person transferring the partnership interest acquired such interest; or

(*2*) The partnership interest being transferred was acquired after the partnership acquired the section 197(f)(9) intangible, provided—

(*i*) The section 197(f)(9) intangible was acquired by the partnership after August 10, 1993, and is not amortizable with respect to the partnership;

(*ii*) The partnership interest being transferred was held after the partnership acquired the section 197(f)(9) intangible by a person or persons (the post-contribution person or persons) other than the person transferring the partnership interest or persons who were related to the person transferring the partnership interest; and

(*iii*) The acquisition of such interest by the post-contribution person or persons was not part of a transaction or series of related transactions in which the person transferring the partnership interest or persons related to the person transferring the partnership interest acquired such interest.

(B) *Acquisition of partnership interest by contribution.* Solely for purposes of paragraph (h)(12)(v)(A) (*1*) and (*2*) of this section, a partner who acquires an interest in a partnership in exchange for a contribution of property to the partnership is deemed to acquire a pro rata portion of that interest in the partnership from each person who is a partner in the partnership at the time of the contribution based on each such partner's proportionate interest in the partnership.

(C) *Effect of retroactive elections.* For purposes of paragraph (h)(12)(v)(A) of this section, references to August 10, 1993, are treated as references to July 25, 1991, if the transferee partner made a valid retroactive election under §1.197–1T.

(vi) *Partner is or becomes a user of partnership intangible*—(A) *General rule.* If, as part of a series of related transactions that includes a transaction described in paragraph (h)(12)(ii), (iii), (iv), or (v) of this section, an anti-churning partner or related person (other than the partnership) becomes (or remains) a direct user of an intangible that is treated as transferred in the transaction (as a result of the partners being treated as having owned their proportionate share of partnership assets), the anti-churning rules of this paragraph (h) apply to the proportionate share of such intangible that is treated as transferred by such anti-churning partner, notwithstanding the application of paragraph (h)(12)(ii), (iii), (iv), or (v) of this section.

(B) *Anti-churning partner.* For purposes of this paragraph (h)(12)(vi), anti-churning partner means—

(*1*) With respect to all intangibles held by a partnership on or before August 10, 1993, any partner, but only to the extent that

(*i*) The partner's interest in the partnership was acquired on or before August 10, 1993, or

(*ii*) The interest was acquired from a person related to the partner on or after August 10, 1993, and such interest was not held by any person other than persons related to such partner at any time after August 10, 1993 (disregarding, for this purpose, a person's holding of an interest if the acquisition of such interest was part of a transaction or series of related transactions in which the partner or persons related to the partner subsequently acquired such interest),

(*2*) With respect to any section 197(f)(9) intangible acquired by a partnership after August 10, 1993, that is not amortizable with respect to the partnership, any partner, but only to the extent that

(*i*) The partner's interest in the partnership was acquired on or before the date the partnership acquired the section 197(f)(9) intangible, or

(*ii*) The interest was acquired from a person related to the partner on or after the date the partnership acquired the section 197(f)(9) intangible, and such interest was not held by any person other than persons related to such partner at any time after the date the partnership acquired the section 197(f)(9) intangible (disregarding, for this purpose, a person's holding of an interest if the acquisition of such interest was part of a transaction or series of related transactions in which the partner or persons related to the partner subsequently acquired such interest).

(C) *Effect of retroactive elections.* For purposes of paragraph (h)(12)(vi)(B) of this section, references to August 10, 1993, are treated as references to July 25, 1991, if the relevant party made a valid retroactive election under §1.197–1T.

(vii) *Section 704(c) allocations*—(A) *Allocations where the intangible is amortizable by the contributor.* The anti-churning rules of this paragraph (h) do not apply to the curative or remedial allocations of amortization with respect to a section 197(f)(9) intangible if the intangible was an amortizable section 197 intangible in the hands of the contributing partner (unless paragraph (h)(10) of this section applies so as to cause the intangible to cease to be an amortizable section 197 intangible in the hands of the partnership).

(B) *Allocations where the intangible is not amortizable by the contributor.* If a section 197(f)(9) intangible was not an amortizable section 197 intangible in the hands of the contributing partner, a non-contributing partner generally may receive remedial allocations of amortization under section 704(c) that are deductible for Federal income tax purposes. However, such a partner may not receive remedial allocations of amortization under section 704(c) if that partner is related to the partner that contributed the intangible or if, as part of a series of related transactions that includes the contribution of the section 197(f)(9) intangible to the partnership, the contributing partner or related person (other than the partnership) becomes (or remains) a direct user of the contributed intangible. Taxpayers may use any reasonable method to determine amortization of the asset for book purposes, provided that the method used does not contravene the purposes of the anti-churning rules under section 197 and this paragraph (h). A method will be considered to contravene the purposes of the anti-churning rules if the effect of the book adjustments resulting from the method is such that any portion of the tax deduction for amortization attributable to section 704(c) is allocated, directly or indirectly, to a partner who is subject to the anti-churning rules with respect to such adjustment.

(C) *Rules for section 721(c) partnerships.* See §1.704–3(d)(5)(iii) if there is a contribution of a section 197(f)(9) intangible to a section 721(c) partnership (as defined in §1.721(c)–1(b)(14)).

(viii) *Operating rule for transfers upon death.* For purposes of this paragraph (h)(12), if the basis of a partner's interest in a partnership is determined under section 1014(a) or 1022, such partner is treated as acquiring such interest from a person who is not related to such partner, and such interest is treated as having previously been held by a person who is not related to such partner.

(i) [Reserved]

(j) *General anti-abuse rule.* The Commissioner will interpret and apply the rules in this section as necessary and appropriate to prevent avoidance of the purposes of section 197. If one of the principal purposes of a transaction is to achieve a tax result that is inconsistent with the purposes of section 197, the Commissioner will recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 197, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances.

(k) *Examples.* The following examples illustrate the application of this section:

Example 1. Advertising costs. (i) Q manufactures and sells consumer products through a series of wholesalers and distributors. In order to increase sales of its products by encouraging consumer loyalty to its products and to enhance the value of the goodwill, trademarks, and trade names of the business, Q advertises its products to the consuming public. It regularly incurs costs to develop radio, television, and print advertisements. These costs generally consist of employee costs and amounts paid to independent advertising agencies. Q also incurs costs to run these advertisements in the various media for which they were developed.

(ii) The advertising costs are not chargeable to capital account under paragraph (f)(3) of this section (relating to costs incurred for covenants not to compete, rights granted by governmental units, and contracts for the use of section 197 intangibles) and are currently deductible as ordinary and necessary expenses under section 162. Accordingly, under paragraph (a)(3) of this section, section 197 does not apply to these costs.

Example 2. Computer software. (i) X purchases all of the assets of an existing trade or business from Y. One of the assets acquired is all of Y's rights in certain computer software previously used by Y under the terms of a nonexclusive license from the software developer. The software was developed for use by manufacturers to maintain a comprehensive accounting system, including general and subsidiary ledgers, payroll, accounts receivable and payable, cash receipts and disbursements, fixed asset accounting, and inventory cost accounting and controls. The developer modified the software for use by Y at a cost of $1,000 and Y made additional modifications at a cost of $500. The developer does not maintain wholesale or retail outlets but markets the software directly to ultimate users. Y's license of the software is limited to an entity that is actively engaged in business as a manufacturer.

(ii) Notwithstanding these limitations, the software is considered to be readily available to the general public for purposes of paragraph (c)(4)(i) of this section. In addition, the software is not substantially modified because the cost of the modifications by the developer and Y to the version of the software that is readily available to the general public does not exceed $2,000. Accordingly, the software is not a section 197 intangible.

Example 3. Acquisition of software for internal use. (i) B, the owner and operator of a worldwide package-delivery service, purchases from S all rights to software developed by S. The software will be used by B for the sole purpose of improving its package-tracking operations. B does not purchase any other assets in the transaction or any related transaction.

(ii) Because B acquired the software solely for internal use, it is disregarded in determining for purposes of paragraph (c)(4)(ii) of this section whether the assets acquired in the transaction or series of related transactions constitute a trade or business or substantial portion thereof. Since no other assets were acquired, the software is not acquired as part of a purchase of a trade or business and under paragraph (c)(4)(ii) of this section is not a section 197 intangible.

Example 4. Governmental rights of fixed duration. (i) City M operates a municipal water system. In order to induce X to locate a new manufacturing business in the city, M grants X the right to purchase water for 16 years at a specified price.

(ii) The right granted by M is a right to receive tangible property or services described in section 197(e)(4)(B) and paragraph (c)(6) of this section and, thus, is not a section 197 intangible. This exclusion applies even though the right does not qualify for exclusion as a right of fixed duration or amount under section 197(e)(4)(D) and paragraph (c)(13) of this section because the duration exceeds 15 years and the right is not fixed as to amount. It is also immaterial that the right would not qualify for exclusion as a self-created intangible under section 197(c)(2) and paragraph (d)(2) of this section because it is granted by a governmental unit.

Example 5. Separate acquisition of franchise. (i) S is a franchiser of retail outlets for specialty coffees. G enters into a franchise agreement (within the meaning of section 1253(b)(1)) with S pursuant to which G is permitted to acquire and operate a store using the S trademark and trade name at the location specified in the agreement. G agrees to pay S $100,000 upon execution of the agreement and also agrees to pay, throughout the term of the franchise, additional amounts that are deductible under section 1253(d)(1). The agreement contains detailed specifications for the construction and operation of the business, but G is not required to purchase from S any of the materials necessary to construct the improvements at the location specified in the franchise agreement.

(ii) The franchise is a section 197 intangible within the meaning of paragraph (b)(10) of this section. The franchise does not qualify for the exclusion relating to self-created intangibles described in section 197(c)(2) and paragraph (d)(2) of this section because the franchise is described in section 197(d)(1)(F). In addition, because the acquisition of the franchise constitutes the acquisition of an interest in a trade or business or a substantial portion thereof, the franchise may not be excluded under section 197(e)(4). Thus, the franchise is an amortizable section 197 intangible, the basis of which must be recovered over a 15-year period. However, the amounts that are deductible under section 1253(d)(1) are not subject to the provisions of section 197 by reason of section 197(f)(4)(C) and paragraph (b)(10)(ii) of this section.

Example 6. Acquisition and amortization of covenant not to compete. (i) As part of the acquisition of a trade or business from C, B and C enter into an agreement containing a covenant not to compete. Under this agreement, C agrees that it will not compete with the business acquired by B within a prescribed geographical territory for a period of three years after the date on which the business is sold to B. In exchange for this agreement, B agrees to pay C $90,000 per year for each year in the term of the agreement. The agreement further provides that, in the event of a breach by C of his obligations under the agreement, B may terminate the agreement, cease making any of the payments due thereafter, and pursue any other legal or equitable remedies available under applicable law. The amounts payable to C under the agreement are not contingent payments for purposes of §1.1275–4. The present fair market value of B's rights under the agreement is $225,000. The aggregate consideration paid excluding any amount treated as interest or original issue discount under applicable provisions of the Internal Revenue Code, for all assets acquired in the transaction (including the covenant not to compete) exceeds the sum of the amount of Class I assets and the aggregate fair market value of all Class II, Class III, Class IV, Class V, and Class VI assets by $50,000. See §1.338–6(b) for rules for determining the assets in each class.

(ii) Because the covenant is acquired in an applicable asset acquisition (within the meaning of section 1060(c)), paragraph (f)(4)(ii) of this section applies and the basis of B in the covenant is determined pursuant to section 1060(a) and the regulations thereunder. Under §§1.1060–1(c)(2) and 1.338–6(c)(1), B's basis in the covenant cannot exceed its fair market value. Thus, B's basis in the covenant immediately after the acquisition is $225,000. This basis is amortized ratably over the 15-year period beginning on the first day of the month in which the agreement is entered into. All of the remaining consideration after allocation to the convenant and other Class VI assets ($50,000) is allocated to Class VII assets (goodwill and going concern value). See §§1.1060–1(c)(2) and 1.338–6(b).

Example 7. Stand-alone license of technology. (i) X is a manufacturer of consumer goods that does business throughout the world through subsidiary corporations organized under the laws of each country in which business is conducted. X licenses to Y, its subsidiary organized and conducting business in Country K, all of the patents, formulas, designs, and know-how necessary for Y to manufacture the same products that X manufactures in the United States. Assume that the license is not considered a sale or exchange under the principles of section 1235. The license is for a term of 18 years, and there are no facts to indicate that the license does not have a fixed duration. Y agrees to pay X a royalty equal to a specified, fixed percentage of the revenues obtained from selling products manufactured using the licensed technology. Assume that the royalty is reasonable and is not subject to adjustment under section 482. The license is not entered into in connection with any other transaction. Y incurs capitalized costs in connection with entering into the license.

(ii) The license is a contract for the use of a section 197 intangible within the meaning of paragraph (b)(11) of this section. It does not qualify for the exception in section 197(e)(4)(D) and paragraph (c)(13) of this section (relating to rights of fixed duration or amount because it does not have a term of less than 15 years, and the other exceptions in section 197(e) and paragraph (c) of this section are also inapplicable. Accordingly, the license is a section 197 intangible.

(iii) The license is not acquired as part of a purchase of a trade or business. Thus, under paragraph (f)(3)(iii) of this section, the license will be closely scrutinized under the principles of section 1235 for purposes of determining whether the transfer is a sale or exchange and, accordingly, whether the payments under the license are chargeable to capital account. Because the license is not a sale or exchange under the principles of section 1235, the royalty payments are not chargeable to capital account for purposes section 197. The capitalized costs of entering into the license are not within the exception under paragraph (d)(2) of this section for self-created intangibles, and thus are amortized under section 197.

Example 8. License of technology and trademarks. (i) The facts are the same as in *Example 7*, except that the license also includes the use of the trademarks and trade names that X uses to manufacture and distribute its products in the United States. Assume that under the principles of section 1253 the transfer is not a sale or exchange of the trademarks and trade names or an undivided interest therein and that the royalty payments are described in section 1253(d)(1)(B).

(ii) As in *Example 7*, the license is a section 197 intangible. Although the license conveys an interest in X's trademarks and trade names to Y, the transfer of the interest is disregarded for purposes of paragraph (e)(2) of this section unless the transfer is considered a sale or exchange of the trademarks and trade names or an undivided interest therein. Accordingly, the licensing of the technology and the trademarks and trade names is not treated as part of a purchase of a trade or business under paragraph (e)(2) of this section.

(iii) Because the technology license is not part of the purchase of a trade or business, it is treated in the manner described in *Example 7*. The royalty payments for the use of the trademarks and trade names are deductible under section 1253(d)(1) and, under section 197(f)(4)(C) and paragraph (b)(10)(ii) of this section, are not chargeable to capital account for purposes of section 197. The capitalized costs of entering into the license are treated in the same manner as in example 7.

Example 9. Disguised sale. (i) The facts are the same as in *Example 7*, except that Y agrees to pay X, in addition to the contingent royalty, a fixed minimum royalty immediately upon entering into the agreement and there are sufficient facts present to characterize the transaction, for federal tax purposes, as a transfer of ownership of the intellectual property from X to Y.

(ii) The purported license of technology is, in fact, an acquisition of an intangible described in section 197(d)(1)(C)(iii) and paragraph (b)(5) of this section (relating to know-how, etc.). As in *Example 7*, the exceptions in section 197(e) and paragraph (c) of this section do not apply to the transfer. Accordingly, the transferred property is a section 197 intangible. Y's basis in the transferred intangible includes the capitalized costs of entering into the agreement and the fixed minimum royalty payment payable at the time of the transfer. In addition, except to the extent that a portion of any payment will be treated as interest or original issue discount under applicable provisions of the Internal Revenue Code, all of the contingent payments under the purported license are properly chargeable to capital account for purposes of section 197 and this section. The extent to which such payments are treated as payments of principal and the time at which any amount treated as a payment of principal is taken into account in determining basis are determined under the rules of §1.1275–4(c)(4) or 1.483–4(a), whichever is applicable. Any contingent amount that is included in basis after the month in which the acquisition occurs is amortized under the rules of paragraph (f)(2)(i) or (ii) of this section.

Example 10. License of technology and customer list as part of sale of a trade or business. (i) X is a computer manufacturer that produces, in separate operating divisions, personal computers, servers, and peripheral equipment. In a transaction that is the purchase of a trade or business for purposes of section 197, Y (who is unrelated to X) purchases from X all assets of the operating division producing personal computers, except for certain patents that are also used in the division manufacturing servers and customer lists that are also used in the division manufacturing peripheral equipment. As part of the transaction, X transfers to Y the right to use the retained patents and customer lists solely in connection with the manufacture and sale of personal computers. The transfer agreement requires annual royalty payments contingent on the use of the patents and also requires a payment for each use of the customer list. In addition, Y incurs capitalized costs in connection with entering into the licenses.

(ii) The rights to use the retained patents and customer lists are contracts for the use of section 197 intangibles within the meaning of paragraph (b)(11) of this section. The rights do not qualify for the exception in 197(e)(4)(D) and paragraph (c)(13) of this section (relating to rights of fixed duration or amount) because they are transferred as part of a purchase of a trade or business and the other exceptions in section 197(e) and paragraph (c) of this section are also inapplicable. Accordingly, the licenses are section 197 intangibles.

(iii) Because the right to use the retained patents is described in paragraph (b)(11) of this section and the right is transferred as part of a purchase of a trade or business, the treatment of the royalty payments is determined under paragraph (f)(3)(ii) of this section. In addition, however, the retained patents are described in paragraph (b)(5) of this section. Thus, the annual royalty payments are chargeable to capital account under the general rule of paragraph (f)(3)(ii)(A) of this section unless Y establishes that the license is not a sale or exchange under the principles of section 1235 and the royalty payments are an arm's length consideration for the rights transferred. If these facts are established, the exception in paragraph (f)(3)(ii)(B) of this section applies and the royalty payments are not chargeable to capital account for purposes of section 197. The capitalized costs of entering into the license are treated in the same manner as in Example 7.

(iv) The right to use the retained customer list is also described in paragraph (b)(11) of this section and is transferred as part of a purchase of a trade or business. Thus, the treatment of the payments for use of the customer list is also determined under paragraph (f)(3)(ii) of this section. The customer list, although described in paragraph (b)(6) of this section, is a customer-related information base. Thus, the exception in paragraph (f)(3)(ii)(B) of this section does not apply. Accordingly, payments for use of the list are chargeable to capital account under the general rule of paragraph (f)(3)(ii)(A) of this section and are amortized under section 197. In addition, the capitalized costs of entering into the contract for use of the customer list are treated in the same manner as in *Example 7*.

Example 11. Loss disallowance rules involving related persons. (i) Assume that X and Y are treated as a single taxpayer for purposes of paragraph (g)(1) of this section. In a single transaction, X and Y acquired from Z all of the assets used by Z in a trade or business. Z had operated this business at two locations, and X and Y each acquired the assets used by Z at one of the locations. Three years after the acquisition, X sold all of the assets it acquired, including amortizable section 197 intangibles, to an unrelated purchaser. The amortizable section intangibles are sold at a loss of $120,000.

(ii) Because X and Y are treated as a single taxpayer for purposes of the loss disallowance rules of section 197(f)(1) and paragraph (g)(1) of this section, X's loss on the sale of the amortizable section 197 intangibles is not recognized. Under paragraph (g)(1)(iv)(B) of this section, X's disallowed loss is allowed ratably, as a deduction under section 197, over the remainder of the 15-year period during which the intangibles would have been amortized, and Y may not increase the basis of the amortizable section 197 intangibles that it acquired from Z by the amount of X's disallowed loss.

Example 12. Disposition of retained intangibles by related person. (i) The facts are the same as in *Example 11*, except that 10 years after the acquisition of the assets by X and Y and 7 years after the sale of the assets by X, Y sells all of the assets acquired from Z, including amortizable section 197 intangibles, to an unrelated purchaser.

(ii) Under paragraph (g)(1)(iv)(B) of this section, X may recognize, on the date of the sale by Y, any loss that has not been allowed as a deduction under section 197. Accordingly, X recognizes a loss of $50,000, the amount obtained by reducing the loss on the sale of the assets at the end of the third year ($120,000) by the amount allowed as a deduction under paragraph (g)(1)(iv)(B) of this section during the 7 years following the sale by X ($70,000).

Example 13. Acquisition of an interest in partnership with no section 754 election. (i) A, B, and C each contribute $1,500 for equal shares in general partnership P. On January 1, 1998, P acquires as its sole asset an amortizable section 197 intangible for $4,500. P still holds the intangible on January 1, 2003, at which time the intangible has an adjusted basis to P of $3,000, and A, B, and C each have an adjusted basis of $1,000 in their partnership interests. D (who is not related to A) acquires A's interest in P for $1,600. No section 754 election is in effect for 2003.

(ii) Because there is no change in the basis of the intangible under section 743(b), D merely steps into the shoes of A with respect to the intangible. D's proportionate share of P's adjusted basis in the intangible is $1,000, which continues to be amortized over the 10 years remaining in the original 15-year amortization period for the intangible.

Example 14. Acquisition of an interest in partnership with a section 754 election. (i) The facts are the same as in *Example 13*, except that a section 754 election is in effect for 2003.

(ii) Pursuant to paragraph (g)(3) of this section, for purposes of section 197, D is treated as if P owns two assets. D's proportionate share of P's adjusted basis in one asset is $1,000, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, D's proportionate share of P's adjusted basis is $600 (the amount of the basis increase under section 743 as a result of the section 754 election), which is amortized over a new 15-year period beginning January 2003. With respect to B and C, P's remaining $2,000 adjusted basis in the intangible continues to be amortized over the 10 years remaining in the original 15-year amortization period.

Example 15. Payment to a retiring partner by partnership with a section 754 election. (i) The facts are the same as in *Example 13*, except that a section 754 election is in effect for 2003 and, instead of D acquiring A's interest in P, A retires from P. A, B, and C are not related to each other within the meaning of paragraph (h)(6) of this section. P borrows $1,600, and A receives a payment under section 736 from P of such amount, all of which is in exchange for A's interest in the intangible asset owned by P. (Assume, for purposes of this example, that the borrowing by P and payment of such funds to A does not give rise to a disguised sale of A's partnership interest under section 707(a)(2)(B).) P makes a positive basis adjustment of $600 with respect to the section 197 intangible under section 734(b).

(ii) Pursuant to paragraph (g)(3) of this section, because of the section 734 adjustment, P is treated as having two amortizable section 197 intangibles, one with a basis of $3,000 and a remaining amortization period of 10 years and the other with a basis of $600 and a new amortization period of 15 years.

Example 16. Termination of partnership under section 708(b)(1)(B). (i) A and B are partners with equal shares in the capital and profits of general partnership P. P's only asset is an amortizable section 197 intangible, which P had acquired on January 1, 1995. On January 1, 2000, the asset had a fair market value of $100 and a basis to P of $50. On that date, A sells his entire partnership interest in P to C, who is unrelated to A, for $50. At the time of the sale, the basis of each of A and B in their respective partnership interests is $25.

(ii) The sale causes a termination of P under section 708(b)(1)(B). Under section 708, the transaction is treated as if P transfers its sole asset to a new partnership in exchange for the assumption of its liabilities and the receipt of all of the interests in the new partnership. Immediately thereafter, P is treated as if it is liquidated, with B and C each receiving their proportionate share of the interests in the new partnership. The contribution by P of its asset to the new partnership is governed by section 721, and the liquidating distributions by P of the interests in the new partnership are governed by section 731. C does not realize a basis adjustment under section 743 with respect to the amortizable section 197 intangible unless P had a section 754 election in effect for its taxable year in which the transfer of the partnership interest to C occurred or the taxable year in which the deemed liquidation of P occurred.

(iii) Under section 197, if P had a section 754 election in effect, C is treated as if the new partnership had acquired two assets from P immediately preceding its termination. Even though the adjusted basis of the new partnership in the two assets is determined solely under section 723, because the transfer of assets is a transaction described in section 721, the application of sections 743(b) and 754 to P immediately before its termination causes P to be treated as if it held two assets for purposes of section 197. See paragraph (g)(3) of this section. B's and C's proportionate share of the new partnership's adjusted basis is $25 each in one asset, which continues to be amortized over the 10 years remaining in the original 15-year amortization period. For the other asset, C's proportionate share of the new partnership's adjusted basis is $25 (the amount of the basis increase resulting from the application of section 743 to the sale or exchange by A of the interest in P), which is amortized over a new 15-year period beginning in January 2000.

(iv) If P did not have a section 754 election in effect for its taxable year in which the sale of the partnership interest by A to C occurred or the taxable year in which the deemed liquidation of P occurred, the adjusted basis of the new partnership in the amortizable section 197 intangible is determined solely under section 723, because the transfer is a transaction described in section 721, and P does not have a basis increase in the intangible. Under section 197(f)(2) and paragraph (g)(2)(ii) of this section, the new partnership continues to amortize the intangible over the 10 years remaining in the original 15-year amortization period. No additional amortization is allowable with respect to this asset.

Example 17. Disguised sale to partnership. (i) E and F are individuals who are unrelated to each other within the meaning of paragraph (h)(6) of this section. E has been engaged in the active conduct of a trade or business as a sole proprietor since 1990. E and F form EF

Partnership. E transfers all of the assets of the business, having a fair market value of $100, to EF, and F transfers $40 of cash to EF. E receives a 60 percent interest in EF and the $40 of cash contributed by F, and F receives a 40 percent interest in EF, under circumstances in which the transfer by E is partially treated as a sale of property to EF under § 1.707–3(b).

(ii) Under § 1.707–3(a)(1), the transaction is treated as if E had sold to EF a 40 percent interest in each asset for $40 and contributed the remaining 60 percent interest in each asset to EF in exchange solely for an interest in EF. Because E and EF are related persons within the meaning of paragraph (h)(6) of this section, no portion of any transferred section 197(f)(9) intangible that E held during the transition period (as defined in paragraph (h)(4) of this section) is an amortizable section 197 intangible pursuant to paragraph (h)(2) of this section. Section 197(f)(9)(F) and paragraph (g)(3) of this section do not apply to any portion of the section 197 intangible in the hands of EF because the basis of EF in these assets was not increased under any of sections 732, 734, or 743.

Example 18. Acquisition by related person in nonrecognition transaction. (i) A owns a nonamortizable intangible that A acquired in 1990. In 2000, A sells a one-half interest in the intangible to B for cash. Immediately after the sale, A and B, who are unrelated to each other, form partnership P as equal partners. A and B each contribute their one-half interest in the intangible to P.

(ii) P has a transferred basis in the intangible from A and B under section 723. The nonrecognition transfer rule under paragraph (g)(2)(ii) of this section applies to A's transfer of its one-half interest in the intangible to P, and consequently P steps into A's shoes with respect to A's nonamortizable transferred basis. The anti-churning rules of paragraph (h) of this section apply to B's transfer of its one-half interest in the intangible to P, because A, who is related to P under paragraph (h)(6) of this section immediately after the series of transactions in which the intangible was acquired by P, held B's one-half interest in the intangible during the transition period. Pursuant to paragraph (h)(10) of this section, these rules apply to B's transfer of its one-half interest to P even though the nonrecognition transfer rule under paragraph (g)(2)(ii) of this section would have permitted P to step into B's shoes with respect to B's otherwise amortizable basis. Therefore, P's entire basis in the intangible is nonamortizable. However, if A (not B) elects to recognize gain under paragraph (h)(9) of this section on the transfer of each of the one-half interests in the intangible to B and P, then the intangible would be amortizable by P to the extent provided in section 197(f)(9)(B) and paragraph (h)(9) of this section.

Example 19. Acquisition of partnership interest following formation of partnership. (i) The facts are the same as in *Example 18* except that, in 2000, A formed P with an affiliate, S, and contributed the intangible to the partnership and except that in a subsequent year, in a transaction that is properly characterized as a sale of a partnership interest for Federal tax purposes, B purchases a 50 percent interest in P from A. P has a section 754 election in effect and holds no assets other than the intangible and cash.

(ii) For the reasons set forth in *Example 16* (iii), B is treated as if P owns two assets. B's proportionate share of P's adjusted basis in one asset is the same as A's proportionate share of P's adjusted basis in that asset, which is not amortizable under section 197. For the other asset, B's proportionate share of the remaining adjusted basis of P is amortized over a new 15-year period.

Example 20. Acquisition by related corporation in nonrecognition transaction. (i) The facts are the same as *Example 18*, except that A and B form corporation P as equal owners.

(ii) P has a transferred basis in the intangible from A and B under section 362. Pursuant to paragraph (h)(10) of this section, the application of the nonrecognition transfer rule under paragraph (g)(2)(ii) of this section and the anti-churning rules of paragraph (h) of this section to the facts of this *Example 18* is the same as in *Example 16*. Thus, P's entire basis in the intangible is nonamortizable.

Example 21. Acquisition from corporation related to purchaser through remote indirect interest. (i) X, Y, and Z are each corporations that have only one class of issued and outstanding stock. X owns 25 percent of the stock of Y and Y owns 25 percent of the outstanding stock of Z. No other shareholder of any of these corporations is related to any other shareholder or to any of the corporations. On June 30, 2000, X purchases from Z section 197(f)(9) intangibles that Z owned during the transition period (as defined in paragraph (h)(4) of this section).

(ii) Pursuant to paragraph (h)(6)(iv)(B) of this section, the beneficial ownership interest of X in Z is 6.25 percent, determined by treating X as if it owned a proportionate (25 percent) interest in the stock of Z that is actually owned by Y. Thus, even though X is related to Y and Y is related to Z, X and Z are not considered to be related for purposes of the anti-churning rules of section 197.

Example 22. Gain recognition election. (i) B owns 25 percent of the stock of S, a corporation that uses the calendar year as its taxable year. No other shareholder of B or S is related to each other. S is not a member of a controlled group of corporations within the meaning of section 1563(a). S has section 197(f)(9) intangibles that it owned during the transition period. S has a basis of $25,000 in the intangibles. In 2001, S sells these intangibles to B for $75,000. S recognizes a gain of

$50,000 on the sale and has no other items of income, deduction, gain, or loss for the year, except that S also has a net operating loss of $20,000 from prior years that it would otherwise be entitled to use in 2001 pursuant to section 172(b). S makes a valid gain recognition election pursuant to section 197(f)(9)(B) and paragraph (h)(9) of this section. In 2001, the highest marginal tax rate applicable to S is 35 percent. But for the election, all of S's taxable income would be taxed at a rate of 15 percent.

(ii) If the gain recognition election had not been made, S would have taxable income of $30,000 for 2001 and a tax liability of $4,500. If the gain were not taken into account, S would have no tax liability for the taxable year. Thus, the amount of tax (other than the tax imposed under paragraph (h)(9) of this section) imposed on the gain is also $4,500. The gain on the disposition multiplied by the highest marginal tax rate is $17,500 ($50,000 × .35). Accordingly, S's tax liability for the year is $4,500 plus an additional tax under paragraph (h)(9) of this section of $13,000 ($17,500—$4,500).

(iii) Pursuant to paragraph (h)(9)(x)(A) of this section, S determines the amount of its net operating loss deduction in subsequent years without regard to the gain recognized on the sale of the section 197 intangible to B. Accordingly, the entire $20,000 net operating loss deduction that would have been available in 2001 but for the gain recognition election may be used in 2002, subject to the limitations of section 172.

(iv) B has a basis of $75,000 in the section 197(f)(9) intangibles acquired from S. As the result of the gain recognition election by S, B may amortize $50,000 of its basis under section 197. Under paragraph (h)(9)(ii) of this section, the remaining basis does not qualify for the gain-recognition exception and may not be amortized by B.

Example 23. Section 338 election. (i) Corporation P makes a qualified stock purchase of the stock of T corporation from two shareholders in July 2000, and a section 338 election is made by P. No shareholder of either T or P owns stock in both of these corporations, and no other shareholder is related to any other shareholder of either corporation.

(ii) Pursuant to paragraph (h)(8) of this section, in the case of a qualified stock purchase that is treated as a deemed sale and purchase of assets pursuant to section 338, the corporation treated as purchasing assets as a result of an election thereunder (new target) is not considered the person that held or used the assets during any period in which the assets were held or used by the corporation treated as selling the assets (old target). Because there are no relationships described in paragraph (h)(6) of this section among the parties to the transaction, any nonamortizable section 197(f)(9) intangible held by old target is an amortizable section 197 intangible in the hands of new target.

(iii) Assume the same facts as set forth in paragraph (i) of this *Example 23*, except that one of the selling shareholders is an individual who owns 25 percent of the total value of the stock of each of the T and P corporation.

(iv) Old target and new target (as these terms are defined in §1.338–2(c)(17)) are members of a controlled group of corporations under section 267(b)(3), as modified by section 197(f)(9)(C)(i), and any nonamortizable section 197(f)(9) intangible held by old target is not an amortizable section 197 intangible in the hands of new target. However, a gain recognition election under paragraph (h)(9) of this section may be made with respect to this transaction.

Example 24. Relationship created as part of public offering. (i) On January 1, 2001, Corporation X engages in a series of related transactions to discontinue its involvement in one line of business. X forms a new corporation, Y, with a nominal amount of cash. Shortly thereafter, X transfers all the stock of its subsidiary conducting the unwanted business (Target) to Y in exchange for 100 shares of Y common stock and a Y promissory note. Target owns a nonamortizable section 197(f)(9) intangible. Prior to January 1, 2001, X and an underwriter (U) had entered into a binding agreement pursuant to which U would purchase 85 shares of Y common stock from X and then sell those shares in a public offering. On January 6, 2001, the public offering closes. X and Y make a section 338(h)(10) election for Target.

(ii) Pursuant to paragraph (h)(8) of this section, in the case of a qualified stock purchase that is treated as a deemed sale and purchase of assets pursuant to section 338, the corporation treated as purchasing assets as a result of an election thereunder (new target) is not considered the person that held or used the assets during any period in which the assets were held or used by the corporation treated as selling the assets (old target). Further, for purposes of determining whether the nonamortizable section 197(f)(9) intangible is acquired by new target from a related person, because the transactions are a series of related transactions, the relationship between old target and new target must be tested immediately before the first transaction in the series (the formation of Y) and immediately after the last transaction in the series (the sale to U and the public offering). See paragraph (h)(6)(ii)(B) of this section. Because there was no relationship between old target and new target immediately before the formation of Y (because the section 338 election had not been made) and only a 15% relationship between old target and new target immediately after, old target is not related to new target for purposes of applying the anti-churning rules of paragraph (h) of this section. Accordingly, Target may amortize the section 197 intangible.

Example 25. Other transfers to controlled corporations. (i) In 2001, Corporation A transfers a section 197(f)(9) intangible that it held during the transition period to X, a newly formed corporation, in exchange for 15% of X's stock. As part of the same transaction, B transfers property to X in exchange for the remaining 85% of X stock.

(ii) Because the acquisition of the intangible by X is part of a qualifying section 351 exchange, under section 197(f)(2) and paragraph (g)(2)(ii) of this section, X is treated in the same manner as the transferor of the asset. Accordingly, X may not amortize the intangible. If, however, at the time of the exchange, B has a binding commitment to sell 25 percent of the X stock to C, an unrelated third party, the exchange, including A's transfer of the section 197(f)(9) intangible, would fail to qualify as a section 351 exchange. Because the formation of X, the transfers of property to X, and the sale of X stock by B are part of a series of related transactions, the relationship between A and X must be tested immediately before the first transaction in the series (the transfer of property to X) and immediately after the last transaction in the series (the sale of X stock to C). See paragraph (h)(6)(ii)(B) of this section. Because there was no relationship between A and X immediately before and only a 15% relationship immediately after, A is not related to X for purposes of applying the anti-churning rules of paragraph (h) of this section. Accordingly, X may amortize the section 197 intangible.

Example 26. Relationship created as part of stock acquisition followed by liquidation. (i) In 2001, Partnership P purchases 100 percent of the stock of Corporation X. P and X were not related prior to the acquisition. Immediately after acquiring the X stock, and as part of a series of related transactions, P liquidates X under section 331. In the liquidating distribution, P receives a section 197(f)(9) intangible that was held by X during the transition period.

(ii) Because the relationship between P and X was created pursuant to a series of related transactions where P acquires stock (meeting the requirements of section 1504(a)(2)) in a fully taxable transaction followed by a liquidation under section 331, the relationship immediately after the last transaction in the series (the liquidation) is disregarded. See paragraph (h)(6)(iii) of this section. Accordingly, P is entitled to amortize the section 197(f)(9) intangible.

Example 27. Section 743(b) adjustment with no change in user. (i) On January 1, 2001, A forms a partnership (PRS) with B in which A owns a 40-percent, and B owns a 60-percent, interest in profits and capital. A contributes a nonamortizable section 197(f)(9) intangible with a value of $80 and an adjusted basis of $0 to PRS in exchange for its PRS interest and B contributes $120 cash. At the time of the contribution, PRS licenses the section 197(f)(9) intangible to A. On February 1, 2001, A sells its entire interest in PRS to C, an unrelated person, for $80. PRS has a section 754 election in effect.

(ii) The section 197(f)(9) intangible contributed to PRS by A is not amortizable in the hands of PRS. Pursuant to section (g)(2)(ii) of this section, PRS steps into the shoes of A with respect to A's nonamortizable transferred basis in the intangible.

(iii) When A sells the PRS interest to C, C will have a basis adjustment in the PRS assets under section 743(b) equal to $80. The entire basis adjustment will be allocated to the intangible because the only other asset held by PRS is cash. Ordinarily, under paragraph (h)(12)(v) of this section, the anti-churning rules will not apply to an increase in the basis of partnership property under section 743(b) if the person acquiring the partnership interest is not related to the person transferring the partnership interest. However, A is an anti-churning partner under paragraph (h)(12)(vi)(B)(*2*)(*i*) of this section. As a result of the license agreement, A remains a direct user of the section 197(f)(9) intangible after the transfer to C. Accordingly, paragraph (h)(12)(vi)(A) of this section will cause the anti-churning rules to apply to the entire basis adjustment under section 743(b).

Example 28. Distribution of section 197(f)(9) intangible to partner who acquired partnership interest prior to the effective date. (i) In 1990, A, B, and C each contribute $150 cash to form general partnership ABC for the purpose of engaging in a consulting business and a software manufacturing business. The partners agree to share partnership profits and losses equally. In 2000, the partnership distributes the consulting business to A in liquidation of A's entire interest in ABC. The only asset of the consulting business is a nonamortizable intangible, which has a fair market value of $180 and a basis of $0. At the time of the distribution, the adjusted basis of A's interest in ABC is $150. A is not related to B or C. ABC does not have a section 754 election in effect.

(ii) Under section 732(b), A's adjusted basis in the intangible distributed by ABC is $150, a $150 increase over the basis of the intangible in ABC's hands. In determining whether the anti-churning rules apply to any portion of the basis increase, A is treated as having owned and used A's proportionate share of partnership property. Thus, A is treated as holding an interest in the intangible during the transition period. Because the intangible was not amortizable prior to the enactment of section 197, the section 732(b) increase in the basis of the intangible may be subject to the anti-churning provisions. Paragraph (h)(12)(ii) of this section provides that the anti-churning provisions apply to the extent that the section 732(b) adjustment exceeds the total unrealized appreciation from the intangible allocable to partners other than A or persons related to A, as well as certain other partners whose purchase of their interests meet certain criteria. Because B and C are not related to A, and A's acquisition of its partnership interest does not satisfy the necessary criteria, the section 732(b) basis increase is subject to the anti-churning provisions to the extent that it exceeds B and C's proportionate share of the unrealized appreciation from the intangible. B and C's proportionate share of the unrealized appreciation from the intangible is $120 (2/3 of $180). This is the amount of gain that would be allocated to B and C if the partnership sold the intangible immediately before the distribution for its fair market value of $180. Therefore, $120 of the section 732(b) basis increase is not subject to the anti-churning rules. The remaining $30 of the section 732(b) basis increase is subject to the anti-churning rules. Accordingly, A is treated as having two intangibles, an amortizable section 197 intangible with an adjusted basis of $120 and a new amortization period of 15 years and a nonamortizable intangible with an adjusted basis of $30.

(iii) In applying the anti-churning rules to future transfers of the distributed intangible, under paragraph (h)(12)(ii)(C) of this section, one-third of the intangible will continue to be subject to the anti-churning rules, determined as follows: The sum of the amount of the distributed intangible's basis that is nonamortizable under paragraph (g)(2)(ii)(B) of this section ($0) and the total unrealized appreciation inherent in the intangible reduced by the amount of the increase in the adjusted basis of the distributed intangible under section 732(b) to which the anti-churning rules do not apply ($180 − $120 = $60), over the fair market value of the distributed intangible ($180).

Example 29. Distribution of section 197(f)(9) intangible to partner who acquired partnership interest after the effective date. (i) The facts are the same as in *Example 28*, except that B and C form ABC in 1990. A does not acquire an interest in ABC until 1995. In 1995, A contributes $150 to ABC in exchange for a one-third interest in ABC. At the time of the distribution, the adjusted basis of A's interest in ABC is $150.

(ii) As in *Example 28*, the anti-churning rules do not apply to the increase in the basis of the intangible distributed to A under section 732(b) to the extent that it does not exceed the unrealized appreciation from the intangible allocable to B and C. Under paragraph (h)(12)(ii) of this section, the anti-churning provisions also do not apply to the section 732(b) basis increase to the extent of A's allocable share of the unrealized appreciation from the intangible because A acquired the ABC interest from an unrelated person after August 10, 1993, and the intangible was acquired by the partnership before A acquired the ABC interest. Under paragraph (h)(12)(ii)(E) of this section, A is deemed to acquire the ABC partnership interest from an unrelated person because A acquired the ABC partnership interest in exchange for a contribution to the partnership of property other than the distributed intangible and, at the time of the contribution, no partner in the partnership was related to A. Consequently, the increase in the basis of the intangible under section 732(b) is not subject to the anti-churning rules to the extent of the total unrealized appreciation from the intangible allocable to A, B, and C. The total unrealized appreciation from the intangible allocable to A, B, and C is $180 (the gain the partnership would have recognized if it had sold the intangible for its fair market value immediately before the distribution). Because this amount exceeds the section 732(b) basis increase of $150, the entire section 732(b) basis increase is amortizable.

(iii) In applying the anti-churning rules to future transfers of the distributed intangible, under paragraph (h)(12)(ii)(C) of this section, one-sixth of the intangible will continue to be subject to the anti-churning rules, determined as follows: The sum of the amount of the distributed intangible's basis that is nonamortizable under paragraph (g)(2)(ii)(B) of this section ($0) and the total unrealized appreciation inherent in the intangible reduced by the amount of the increase in the adjusted basis of the distributed intangible under section 732(b) to which the anti-churning rules do not apply ($180 − $150 = $30), over the fair market value of the distributed intangible ($180).

Example 30. Distribution of section 197(f)(9) intangible contributed to the partnership by a partner. (i) The facts are the same as in *Example 29*, except that C purchased the intangible used in the consulting business in 1988 for $60 and contributed the intangible to ABC in 1990. At that time, the intangible had a fair market value of $150 and an adjusted tax basis of $60. When ABC distributes the intangible to A in 2000, the intangible has a fair market value of $180 and a basis of $60.

(ii) As in *Examples 28* and *29*, the adjusted basis of the intangible in A's hands is $150 under section 732(b). However, the increase in the adjusted basis of the intangible under section 732(b) is only $90 ($150 adjusted basis after the distribution compared to $60 basis before the distribution). Pursuant to paragraph (g)(2)(ii)(B) of this section, A steps into the shoes of ABC with respect to the $60 of A's adjusted basis in the intangible that corresponds to ABC's basis in the intangible and this portion of the basis is nonamortizable. B and C are not related to A, A acquired the ABC interest from an unrelated person after August 10, 1993, and the intangible was acquired by ABC before A acquired the ABC interest. Therefore, under paragraph (h)(12)(ii) of this section, the section 732(b) basis increase is amortizable to the extent of A, B, and C's allocable share of the unrealized appreciation from the intangible. The total unrealized appreciation from the intangible that is allocable to A, B, and C is $120. If ABC had sold the intangible immediately before the distribution to A for its fair market value of $180, it would have recognized gain of $120, which would have been allocated $10 to A, $10 to B, and $100 to C under section 704(c). Because A, B, and C's allocable share of the unrealized appreciation from the intangible exceeds the section 732(b) basis increase in the intangible, the entire $90 of basis increase is amortizable by A. Accordingly, after the distribution, A will be treated as having two intangibles, an amortizable section 197 intangible with an adjusted basis of $90 and a new amortization period of 15 years and a nonamortizable intangible with an adjusted basis of $60.

(iii) In applying the anti-churning rules to future transfers of the distributed intangible, under paragraph (h)(12)(ii)(C) of this section, one-half of the intangible will continue to be subject to the anti-churning rules, determined as follows: The sum of the amount of the distributed intangible's basis that is nonamortizable under paragraph (g)(2)(ii)(B) of this section ($60) and the total unrealized appreciation inherent in the intangible reduced by the amount of the increase in the adjusted basis of the distributed intangible under section 732(b) to which the anti-churning rules do not apply ($120 − $90 = $30), over the fair market value of the distributed intangible ($180).

Example 31. Partnership distribution causing section 734(b) basis adjustment to section 197(f)(9) intangible. (i) On January 1, 2001, A, B, and C form a partnership (ABC) in which each partner shares equally in capital and income, gain, loss, and deductions. On that date, A contributes a section 197(f)(9) intangible with a zero basis and a value of $150, and B and C each contribute $150 cash. A and B are related, but neither A nor B is related to C. ABC does not adopt the remedial allocation method for making section 704(c) allocations of amortization expenses with respect to the intangible. On December 1, 2004, when the value of the intangible has increased to $600, ABC distributes $300 to B in complete redemption of B's interest in the partnership. ABC has an election under section 754 in effect for the taxable year that includes December 1, 2004. (Assume that, at the time of the distribution, the basis of A's partnership interest remains zero, and the basis of each of B's and C's partnership interest remains $150.)

(ii) Immediately prior to the distribution, the assets of the partnership are revalued pursuant to §1.704–1(b)(2)(iv)(*f*), so that the section 197(f)(9) intangible is reflected on the books of the partnership at a value of $600. B recognizes $150 of gain under section 731(a)(1) upon the distribution of $300 in redemption of B's partnership interest. As a result, the adjusted basis of the intangible held by ABC increases by $150 under section 734(b). A does not satisfy any of the tests set forth under paragraph (h)(12)(iv)(B) and thus is not an eligible partner. C is not related to B and thus is an eligible partner under paragraph (h)(12)(iv)(B)(*1*) of this section. The capital accounts of A and C are equal immediately after the distribution, so, pursuant to paragraph (h)(12)(iv)(D)(*1*) of this section, each partner's share of the basis increase is equal to $75. Because A is not an eligible partner, the anti-churning rules apply to A's share of the basis increase. The anti-churning rules do not apply to C's share of the basis increase.

(iii) For book purposes, ABC determines the amortization of the asset as follows: First, the intangible that is subject to adjustment under section 734(b) will be divided into three assets: the first, with a basis and value of $75 will be amortizable for both book and tax purposes; the second, with a basis and value of $75 will be amortizable for book, but not tax purposes; and a third asset with a basis of zero and a value of $450 will not be amortizable for book or tax purposes. Any subsequent revaluation of the intangible pursuant to §1.704–1(b)(2)(iv)(*f*) will be made solely with respect to the third asset (which is not amortizable for book purposes). The book and tax attributes from the first asset (*i.e.*, book and tax amortization) will be specially allocated to C. The book and tax attributes from the second asset (*i.e.*, book amortization and non-amortizable tax basis) will be specially allocated to A. Upon disposition of the intangible, each partner's share of gain or loss will be determined first by allocating among the partners an amount realized equal to the book value of the intangible attributable to such partner, with any remaining amount realized being allocated in accordance with the partnership agreement. Each partner then will compare its share of the amount realized with its remaining basis in the intangible to arrive at the gain or loss to be allocated to such partner. This is a reasonable method for amortizing the intangible for book purposes, and the results in allocating the income, gain, loss, and deductions attributable to the intangible do not contravene the purposes of the anti-churning rules under section 197 or paragraph (h) of this section.

(l) *Effective dates*—(1) *In general.* This section applies to property acquired after January 25, 2000, except that paragraph (c)(13) of this section (exception from section 197 for separately acquired rights of fixed duration or amount) applies to property acquired after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under §1.197–1T), and paragraphs (h)(12)(ii), (iii), (iv), (v), (vi)(A), and (vii)(B) of this section (anti-churning rules applicable to partnerships) apply to partnership transactions occurring on or after November 20, 2000.

(2) *Application to pre-effective date acquisitions.* A taxpayer may choose, on a transaction-by-transaction basis, to apply the provisions of this section and §1.167(a)–14 to property acquired (or partnership transactions occurring) after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under §1.197–1T) and—

(i) On or before January 25, 2000; or

(ii) With respect to paragraphs (h)(12)(ii), (iii), (iv), (v), (vi)(A), and (vii)(B) of this section, before November 20, 2000.

(3) *Application of regulation project REG–209709–94 to pre-effective date acquisitions.* A taxpayer may rely on the provisions of regulation project REG–209709–94 (1997–1 C.B. 731) for property acquired after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under §1.197–1T) and on or before January 25, 2000.

(4) *Change in method of accounting*—(i) *In general.* For the first taxable year ending after January 25, 2000, a taxpayer that has acquired property to which the exception in §1.197–2(c)(13) applies is granted consent of the Commissioner to change its method of accounting for such property to comply with the provisions of this section and §1.167(a)–14 unless the proper treatment of such property is an issue under consideration (within the meaning of Rev. Proc. 97–27 (1997–21 IRB 10)(see §601.601(d)(2) of this chapter)) in an examination, before an Appeals office, or before a Federal court.

(ii) *Application to pre-effective date acquisitions.* For the first taxable year ending after January 25, 2000, a taxpayer is granted consent of the Commissioner to change its method of accounting for all property acquired in transactions described in paragraph (l)(2) of this section to comply with the provisions of this section and §1.167(a)–14 unless the proper treatment of any such property is an issue under consideration (within the meaning of Rev. Proc. 97–27 (1997–21 IRB 10)(see §601.601(d)(2) of this chapter)) in an examination, before an Appeals office, or before a Federal court.

(iii) *Automatic change procedures.* A taxpayer changing its method of accounting in accordance with this paragraph (l)(4) must follow the automatic change in accounting method provisions of Rev. Proc. 99–49 (1999–52 IRB 725)(see §601.601(d)(2) of this chapter) except, for purposes of this paragraph (l)(4), the scope limitations in section 4.02 of Rev. Proc. 99–49 (1999–52 IRB 725) are not applicable. However, if the taxpayer is under examination, before an appeals office, or before a Federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the National Office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(5) *Applicability dates for section 721(c) partnerships*—(i) *In general.* Except as provided in paragraph (l)(5)(ii) of this section, paragraph (h)(12)(vii)(C) of this section applies with respect to contributions occurring on or after January 18, 2017, and with respect to contributions that occurred before January 18, 2017 resulting from an entity classification election made under §301.7701–3 of this chapter that was effective on or before January 18, 2017 but was filed on or after January 18, 2017.

(ii) *Application of the provisions described in paragraph (l)(5)(i)(A) of this section retroactively.* Paragraph (h)(12)(vii)(C) of this section may be applied with respect to a contribution occurring on or after August 6, 2015, and to a contribution that occurred before August 6, 2015 resulting from an entity classification election made under §301.7701–3 of this chapter that was effective on or before August 6, 2015 but was filed on or after August 6, 2015. A taxpayer applying paragraph (h)(12)(vii)(C) of this section retroactively must apply paragraph (h)(12)(vii)(C) of this section on a timely filed original return (including extensions) or an amended return filed no later than July 18, 2017.

[T.D. 8865, 65 FR 3827, Jan. 25, 2000; 65 FR 16318, Mar. 28, 2000; 65 FR 60585, Oct. 12, 2000, as amended by T.D. 8907, 65 FR 69671, Nov. 20, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001; 66 FR 17363, Mar. 30, 2001; 67 FR 22286, May 3, 2002; T.D. 9257, 71 FR 17996, Apr. 10, 2006; 73 FR 3869, Jan. 23, 2008; T.D. 9533, 76 FR 39280, July 6, 2011; T.D. 9637, 78 FR 54745, Sept. 6, 2013; T.D. 9811, 82 FR 6237, Jan. 19, 2017; T.D. 9814, 82 FR 7597, Jan. 19, 2017; T.D. 9891, 84 FR 3838, Jan. 23, 2020]

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[T.D. 9847, 84 FR 2988, Feb. 8, 2019; T.D. 9847, 84 FR 15954, Apr. 17, 2019; T.D. 9899, 85 FR 38065, June 25, 2020]

EDITORIAL NOTE: At 84 FR 15954, Apr. 17, 2019, § 1.199A–0 was amended be adding an entry for § 1.199A–2(b)(2)(iv), however, this paragraph already exists and the amendment could not be incorporated due to inaccurate amendatory instruction.

§ 1.199A–1 Operational rules.

(a) *Overview*—(1) *In general.* This section provides operational rules for calculating the section 199A(a) qualified business income deduction (section 199A deduction) under section 199A of the Internal Revenue Code (Code). This section refers to the rules in §§ 1.199A–2 through 1.199A–6. This paragraph (a) provides an overview of this section. Paragraph (b) of this section provides definitions that apply for purposes of section 199A and §§ 1.199A–1 through 1.199A–6. Paragraph (c) of this section provides computational rules and examples for individuals whose taxable income does not exceed the threshold amount. Paragraph (d) of this section provides computational rules and examples for individuals whose taxable income exceeds the threshold amount. Paragraph (e) of this section provides special rules for purposes of section 199A and §§ 1.199A–1 through 1.199A–6. This section and §§ 1.199A–2 through 1.199A–6 do not apply for purposes of calculating the deduction in section 199A(g) for specified agricultural and horticultural cooperatives.

(2) *Usage of term individual.* For purposes of applying the rules of §§ 1.199A–1 through 1.199A–6, a reference to an individual includes a reference to a trust (other than a grantor trust) or an estate to the extent that the section 199A deduction is determined by the trust or estate under the rules of § 1.199A–6.

(b) *Definitions.* For purposes of section 199A and §§ 1.199A–1 through 1.199A–6, the following definitions apply:

(1) *Aggregated trade or business* means two or more trades or businesses that have been aggregated pursuant to § 1.199A–4.

(2) *Applicable percentage* means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return).

(3) *Net capital gain* means *net capital gain* as defined in section 1222(11) plus any *qualified dividend income* (as defined in section 1(h)(11)(B)) for the taxable year.

(4) *Phase-in range* means a range of taxable income between the threshold amount and the threshold amount plus $50,000 (or $100,000 in the case of a joint return).

(5) *Qualified business income (QBI)* means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business (or aggregated trade or business) as determined under the rules of § 1.199A–3(b).

(6) *QBI component* means the amount determined under paragraph (d)(2) of this section.

(7) *Qualified PTP income* is defined in § 1.199A–3(c)(3).

(8) *Qualified REIT dividends* are defined in § 1.199A–3(c)(2).

(9) *Reduction amount* means, with respect to any taxable year, the excess amount multiplied by the ratio that the taxable income of the individual for the taxable year in excess of the threshold amount, bears to $50,000 (or $100,000 in the case of a joint return). For purposes of this paragraph (b)(9), the *excess amount* is the amount by which 20 percent of QBI exceeds the greater of 50 percent of W–2 wages or the sum of 25 percent of W–2 wages plus 2.5 percent of the UBIA of qualified property.

(10) *Relevant passthrough entity (RPE)* means a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust. Other passthrough entities including common trust funds as described in § 1.6032–1T and religious or apostolic organizations described in section 501(d) are also treated as RPEs if the entity files a Form 1065, *U.S. Return of Partnership Income*, and is owned, directly or indirectly, by at least one individual, estate, or trust. A trust or estate is treated as an RPE to the extent it passes through QBI, W–2 wages,

UBIA of qualified property, qualified REIT dividends, or qualified PTP income.

(11) *Specified service trade or business (SSTB)* means a specified service trade or business as defined in §1.199A–5(b).

(12) *Threshold amount* means, for any taxable year beginning before 2019, $157,500 (or $315,000 in the case of a taxpayer filing a joint return). In the case of any taxable year beginning after 2018, the threshold amount is the dollar amount in the preceding sentence increased by an amount equal to such dollar amount, multiplied by the cost-of-living adjustment determined under section 1(f)(3) of the Code for the calendar year in which the taxable year begins, determined by substituting ''calendar year 2017'' for ''calendar year 2016'' in section 1(f)(3)(A)(ii). The amount of any increase under the preceding sentence is rounded as provided in section 1(f)(7) of the Code.

(13) *Total QBI amount* means the net total QBI from all trades or businesses (including the individual's share of QBI from trades or business conducted by RPEs).

(14) *Trade or business* means a trade or business that is a trade or business under section 162 (a section 162 trade or business) other than the trade or business of performing services as an employee. In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A–4(b)(1)(i) (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under §1.199A–4(b)(1)).

(15) *Unadjusted basis immediately after acquisition of qualified property* (*UBIA of qualified property*) is defined in §1.199A–2(c).

(16) *W–2 wages* means W–2 wages of a trade or business (or aggregated trade or business) properly allocable to QBI as determined under §1.199A–2(b).

(c) *Computation of the section 199A deduction for individuals with taxable income not exceeding threshold amount*—(1) *In general.* The section 199A deduction is determined for individuals with taxable income for the taxable year that does not exceed the threshold amount by adding 20 percent of the total QBI amount (including the individual's share of QBI from an RPE and QBI attributable to an SSTB) and 20 percent of the combined amount of qualified REIT dividends and qualified PTP income (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs and qualified PTP income attributable to an SSTB). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

(2) *Carryover rules*—(i) *Negative total QBI amount.* If the total QBI amount is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the taxable year. The negative total QBI amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(ii) *Negative combined qualified REIT dividends/qualified PTP income.* If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends and qualified PTP income in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (c). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section and all of the tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c). Total taxable income does not include the section 199A deduction.

(i) *Example 1.* A, an unmarried individual, owns and operates a computer repair shop as a sole proprietorship. The business generates $100,000 in net taxable income from operations in 2018. A has no capital gains or losses. After allowable deductions not relating to the business, A's total taxable income for 2018 is $81,000. The business's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. A's section 199A deduction for 2018 is equal to $16,200, the lesser of 20% of A's QBI from the business ($100,000 × 20% = $20,000) and 20% of A's total taxable income for the taxable year ($81,000 × 20% = $16,200).

(ii) *Example 2.* Assume the same facts as in *Example 1* of paragraph (c)(3)(i) of this section, except that A also has $7,000 in net capital gain for 2018 and that, after allowable deductions not relating to the business, A's taxable income for 2018 is $74,000. A's taxable income minus net capital gain is $67,000 ($74,000 − $7,000). A's section 199A deduction is equal to $13,400, the lesser of 20% of A's QBI from the business ($100,000 × 20% = $20,000) and 20% of A's total taxable income minus net capital gain for the taxable year ($67,000 × 20% = $13,400).

(iii) *Example 3.* B and C are married and file a joint individual income tax return. B earns $50,000 in wages as an employee of an unrelated company in 2018. C owns 100% of the shares of X, an S corporation that provides landscaping services. X generates $100,000 in net income from operations in 2018. X pays C $150,000 in wages in 2018. B and C have no capital gains or losses. After allowable deductions not related to X, B and C's total taxable income for 2018 is $270,000. B's and C's wages are not considered to be income from a trade or business for purposes of the section 199A deduction. Because X is an S corporation, its QBI is determined at the S corporation level. X's QBI is $100,000, the net amount of its qualified items of income, gain, deduction, and loss. The wages paid by X to C are considered to be a qualified item of deduction for purposes of determining X's QBI. The section 199A deduction with respect to X's QBI is then determined by C, X's sole shareholder, and is claimed on the joint return filed by B and C. B and C's section 199A deduction is equal to $20,000, the lesser of 20% of C's QBI from the business ($100,000 × 20% = $20,000) and 20% of B and C's total taxable income for the taxable year ($270,000 × 20% = $54,000).

(iv) *Example 4.* Assume the same facts as in *Example 3* of paragraph (c)(3)(iii) of this section except that B also earns $1,000 in qualified REIT dividends and $500 in qualified PTP income in 2018, increasing taxable income to $271,500. B and C's section 199A deduction is equal to $20,300, the lesser of:

(A) 20% of C's QBI from the business ($100,000 × 20% = $20,000) plus 20% of B's combined qualified REIT dividends and qualified PTP income ($1,500 × 20% = $300); and

(B) 20% of B and C's total taxable for the taxable year ($271,500 × 20% = $54,300).

(d) *Computation of the section 199A deduction for individuals with taxable income above threshold amount*—(1) *In general.* The section 199A deduction is determined for individuals with taxable income for the taxable year that exceeds the threshold amount by adding the QBI component described in paragraph (d)(2) of this section and the qualified REIT dividends/qualified PTP income component described in paragraph (d)(3) of this section (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs). That sum is then compared to 20 percent of the amount by which the individual's taxable income exceeds net capital gain. The lesser of these two amounts is the individual's section 199A deduction.

(2) *QBI component.* An individual with taxable income for the taxable year that exceeds the threshold amount determines the QBI component using the

following computational rules, which are to be applied in the order they appear.

(i) *SSTB exclusion.* If the individual's taxable income is within the phase-in range, then only the applicable percentage of QBI, W–2 wages, and UBIA of qualified property for each SSTB is taken into account for all purposes of determining the individual's section 199A deduction, including the application of the netting and carryover rules described in paragraph (d)(2)(iii) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of QBI, W–2 wages, or UBIA of qualified property attributable to an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.

(ii) *Aggregated trade or business.* If an individual chooses to aggregate trades or businesses under the rules of §1.199A–4, the individual must combine the QBI, W–2 wages, and UBIA of qualified property of each trade or business within an aggregated trade or business prior to applying the netting and carryover rules described in paragraph (d)(2)(iii) of this section and the W–2 wage and UBIA of qualified property limitations described in paragraph (d)(2)(iv) of this section.

(iii) *Netting and carryover*—(A) *Netting.* If an individual's QBI from at least one trade or business (including an aggregated trade or business) is less than zero, the individual must offset the QBI attributable to each trade or business (or aggregated trade or business) that produced net positive QBI with the QBI from each trade or business (or aggregated trade or business) that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses (or aggregated trades or businesses) with positive QBI. The adjusted QBI is then used in paragraph (d)(2)(iv) of this section. The W–2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(B) *Carryover of negative total QBI amount.* If an individual's QBI from all trades or businesses (including aggregated trades or businesses) combined is less than zero, the QBI component is zero for the taxable year. This negative amount is treated as negative QBI from a separate trade or business in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code. The W–2 wages and UBIA of qualified property from the trades or businesses (including aggregated trades or businesses) that produced net negative QBI are not taken into account for purposes of this paragraph (d) and are not carried over to the subsequent year.

(iv) *QBI component calculation*—(A) *General rule.* Except as provided in paragraph (d)(2)(iv)(B) of this section, the QBI component is the sum of the amounts determined under this paragraph (d)(2)(iv)(A) for each trade or business (or aggregated trade or business). For each trade or business (or aggregated trade or business) (including trades or businesses operated through RPEs) the individual must determine the lesser of—

(*1*) 20 percent of the QBI for that trade or business (or aggregated trade or business); or

(*2*) The greater of—

(*i*) 50 percent of W–2 wages with respect to that trade or business (or aggregated trade or business); or

(*ii*) The sum of 25 percent of W–2 wages with respect to that trade or business (or aggregated trade or business) plus 2.5 percent of the UBIA of qualified property with respect to that trade or business (or aggregated trade or business).

(B) *Taxpayers with taxable income within phase-in range.* If the individual's taxable income is within the phase-in range and the amount determined under paragraph (d)(2)(iv)(A)(*2*) of this section for a trade or business (or aggregated trade or business) is less than the amount determined under paragraph (d)(2)(iv)(A)(*1*) of this section for that trade or business (or aggregated trade or business), the amount determined under paragraph (d)(2)(iv)(A) of this section for such trade or business (or aggregated trade or business) is modified. Instead of the amount determined under paragraph (d)(2)(iv)(A)(*2*) of this section, the QBI component for the trade or business (or aggregated trade or business) is the amount determined under paragraph (d)(2)(iv)(A)(*1*) of this section reduced by the reduction amount as defined in paragraph (b)(9) of this section. This reduction amount does not apply if the amount determined in paragraph (d)(2)(iv)(A)(*2*) of this section is greater than the amount determined under paragraph (d)(2)(iv)(A)(*1*) of this section (in which circumstance the QBI component for the trade or business (or aggregated trade or business) will be the unreduced amount determined in paragraph (d)(2)(iv)(A)(*1*) of this section).

(3) *Qualified REIT dividends/qualified PTP income component*—(i) *In general.* The qualified REIT dividend/qualified PTP income component is 20 percent of the combined amount of qualified REIT dividends and qualified PTP income received by the individual (including the individual's share of qualified REIT dividends and qualified PTP income from RPEs).

(ii) *SSTB exclusion.* If the individual's taxable income is within the phase-in range, then only the applicable percentage of qualified PTP income generated by an SSTB is taken into account for purposes of determining the individual's section 199A deduction, including the determination of the combined amount of qualified REIT dividends and qualified PTP income described in paragraph (d)(1) of this section. If the individual's taxable income exceeds the phase-in range, then none of the individual's share of qualified PTP income generated by an SSTB may be taken into account for purposes of determining the individual's section 199A deduction.

(iii) *Negative combined qualified REIT dividends/qualified PTP income.* If the combined amount of REIT dividends and qualified PTP income is less than zero, the portion of the individual's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for the taxable year. The negative combined amount must be carried forward and used to offset the combined amount of REIT dividends/qualified PTP income in the succeeding taxable years of the individual for purposes of section 199A and this section. This carryover rule does not affect the deductibility of the loss for purposes of other provisions of the Code.

(4) *Examples.* The following examples illustrate the provisions of this paragraph (d). For purposes of these examples, unless indicated otherwise, assume that all of the trades or businesses are trades or businesses as defined in paragraph (b)(14) of this section, none of the trades or businesses are SSTBs as defined in paragraph (b)(11) of this section and § 1.199A–5(b); and all of the tax items associated with the trades or businesses are effectively connected to a trade or business within the United States within the meaning of section 864(c). Also assume that the taxpayers report no capital gains or losses or other tax items not specified in the examples. Total taxable income does not include the section 199A deduction.

(i) *Example 1.* D, an unmarried individual, operates a business as a sole proprietorship. The business generates $1,000,000 of QBI in 2018. Solely for purposes of this example, assume that the business paid no wages and holds no qualified property for use in the business. After allowable deductions unrelated to the business, D's total taxable income for 2018 is $980,000. Because D's taxable income exceeds the applicable threshold amount, D's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. D's section 199A deduction is limited to zero because the business paid no wages and held no qualified property.

(ii) *Example 2.* Assume the same facts as in *Example 1* of paragraph (d)(4)(i) of this section, except that D holds qualified property with a UBIA of $10,000,000 for use in the trade or business. D reports $4,000,000 of QBI for 2020. After allowable deductions unrelated to the business, D's total taxable income for 2020 is $3,980,000. Because D's taxable income is above the threshold amount, the QBI component of D's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. Because the business has no W–2 wages, the QBI component of D's section 199A deduction is limited to the lesser of 20% of the business's QBI or 2.5% of its UBIA of qualified property. Twenty percent of the $4,000,000 of QBI is $800,000. Two and one-half percent of the $10,000,000 UBIA of qualified property is $250,000. The QBI component of D's section 199A deduction is thus limited to $250,000. D's section 199A deduction is equal to the lesser of:

(A) 20% of the QBI from the business as limited ($250,000); or

(B) 20% of D's taxable income ($3,980,000 × 20% = $796,000). Therefore, D's section 199A deduction for 2020 is $250,000.

(iii) *Example 3.* E, an unmarried individual, is a 30% owner of LLC, which is classified as a partnership for Federal income tax purposes. In 2018, the LLC has a single trade or business and reports QBI of $3,000,000. The LLC pays total W–2 wages of $1,000,000, and its total UBIA of qualified property is $100,000. E is allocated 30% of all items of the partnership. For the 2018 taxable year, E reports $900,000 of QBI from the LLC. After allowable deductions unrelated to LLC, E's taxable income is $880,000. Because E's taxable income is above the threshold amount, the QBI component of E's section 199A deduction will be limited to the lesser of 20% of E's share of LLC's QBI or the greater of the W–2 wage or UBIA of qualified property limitations. Twenty percent of E's share of QBI of $900,000 is $180,000. The W–2 wage limitation equals 50% of E's share of the LLC's wages ($300,000) or $150,000. The UBIA of qualified property limitation equals $75,750, the sum of 25% of E's share of LLC's wages ($300,000) or $75,000 plus 2.5% of E's share of UBIA of qualified property ($30,000) or $750. The greater of the limitation amounts ($150,000 and $75,750) is $150,000. The QBI component of E's section 199A deduction is thus limited to $150,000, the lesser of 20% of QBI ($180,000) and the greater of the limitations amounts ($150,000). E's section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($150,000) or 20% of E's taxable income ($880,000 × 20% = $176,000). Therefore, E's section 199A deduction is $150,000 for 2018.

(iv) *Example 4.* F, an unmarried individual, owns a 50% interest in Z, an S corporation for Federal income tax purposes that conducts a single trade or business. In 2018, Z reports QBI of $6,000,000. Z pays total W–2 wages of $2,000,000, and its total UBIA of qualified property is $200,000. For the 2018 taxable year, F reports $3,000,000 of QBI from Z. F is not an employee of Z and receives no wages or reasonable compensation from Z. After allowable deductions unrelated to Z and a deductible qualified net loss from a PTP of ($10,000), F's taxable income is $1,880,000. Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction will be limited to the lesser of 20% of F's share of Z's QBI or the greater of the W–2 wage and UBIA of qualified property limitations. Twenty percent of F's share of Z's QBI ($3,000,000) is $600,000. The W–2 wage limitation equals 50% of F's share of Z's W–2 wages ($1,000,000) or $500,000. The UBIA of qualified property limitation equals $252,500, the sum of 25% of F's share of Z's W–2 wages ($1,000,000) or $250,000 plus 2.5% of E's share of UBIA of qualified property ($100,000) or $2,500. The greater of the limitation amounts ($500,000 and $252,500) is $500,000. The QBI component of F's section 199A deduction is thus limited to $500,000, the lesser of 20% of QBI ($600,000) and the greater of the limitations amounts ($500,000). F reports a qualified loss from a PTP and has no qualified REIT dividend. F does not net the ($10,000) loss from the PTP against QBI. Instead, the portion of F's section 199A deduction related to qualified REIT dividends and qualified PTP income is zero for 2018. F's section is 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($500,000) or 20% of F's taxable income over net capital gain ($1,880,000 x 20% = $376,000). Therefore, F's section 199A deduction is $376,000 for 2018. F must also carry forward the ($10,000) qualified loss from a PTP to be netted against F's qualified REIT dividends and qualified PTP income in the succeeding taxable year.

(v) *Example 5: Phase-in range.* (A) B and C are married and file a joint individual income tax return. B is a shareholder in M, an entity taxed as an S corporation for Federal income tax purposes that conducts a single trade or business. M holds no qualified property. B's share of the M's QBI is $300,000 in 2018. B's share of the W–2 wages from M in 2018 is $40,000. C earns wage income from employment by an unrelated company. After allowable deductions unrelated to M, B and C's taxable income for 2018 is $375,000. B and C are within the phase-in range because their taxable income exceeds the applicable threshold amount, $315,000, but does not exceed the threshold amount plus $100,000, or $415,000. Consequently, the QBI component of B and C's section 199A deduction may be limited by the W–2 wage and UBIA of qualified property limitations but the limitations will be phased in.

(B) Because M does not hold qualified property, only the W–2 wage limitation must be calculated. In order to apply the W–2 wage limitation, B and C must first determine 20% of B's share of M's QBI. Twenty percent of B's share of M's QBI of $300,000 is $60,000. Next, B and C must determine 50% of B's share of M's W–2 wages. Fifty percent of B's share of M's W–2 wages of $40,000 is $20,000. Because 50% of B's share of M's W–2 wages ($20,000) is less than 20% of B's share of M's QBI ($60,000), B and C must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, or $60,000, over 50% of B's share of M's W–2 wages, or $20,000. Thus, the excess amount is $40,000. The reduction amount is equal to 60% of the excess amount, or $24,000. Thus, the QBI component of B and C's section 199A deduction is equal to $36,000, 20% of B's $300,000 share M's QBI (that is, $60,000), reduced by $24,000. B and C's section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($36,000) or 20% of B and C's taxable income ($375,000 × 20% = $75,000). Therefore, B and C's section 199A deduction is $36,000 for 2018.

(vi) *Example 6*. (A) Assume the same facts as in *Example 5* of paragraph (d)(4)(v) of this section, except that M is engaged in an SSTB. Because B and C are within the phase-in range, B must reduce the QBI and W–2 wages allocable to B from M to the applicable percentage of those items. B and C's applicable percentage is 100% reduced by the percentage equal to the ratio that their taxable income for the taxable year ($375,000) exceeds their threshold amount ($315,000), or $60,000, bears to $100,000. Their applicable percentage is 40%. The applicable percentage of B's QBI is ($300,000 × 40% =) $120,000, and the applicable percentage of B's share of W–2 wages is ($40,000 × 40% =) $16,000. These reduced numbers must then be used to determine how B's section 199A deduction is limited.

(B) B and C must apply the W–2 wage limitation by first determining 20% of B's share of M's QBI as limited by paragraph (d)(4)(vi)(A) of this section. Twenty percent of B's share of M's QBI of $120,000 is $24,000. Next, B and C must determine 50% of B's share of M's W–2 wages. Fifty percent of B's share of M's W–2 wages of $16,000 is $8,000. Because 50% of B's share of M's W–2 wages ($8,000) is less than 20% of B's share of M's QBI ($24,000), B and C's must determine the QBI component of their section 199A deduction by reducing 20% of B's share of M's QBI by the reduction amount.

(C) B and C are 60% through the phase-in range (that is, their taxable income exceeds the threshold amount by $60,000 and their phase-in range is $100,000). B and C must determine the excess amount, which is the excess of 20% of B's share of M's QBI, as adjusted in paragraph (d)(4)(vi)(A) of this section or $24,000, over 50% of B's share of M's W–2 wages, as adjusted in paragraph (d)(4)(vi)(A) of this section, or $8,000. Thus, the excess amount is $16,000. The reduction amount is equal to 60% of the excess amount or $9,600. Thus, the QBI component of B and C's section 199A deduction is equal to $14,400, 20% of B's share M's QBI of $24,000, reduced by $9,600. B and C's section 199A deduction is equal to the lesser of 20% of the QBI from the business as limited ($14,400) or 20% of B's and C's taxable income ($375,000 × 20% = $75,000). Therefore, B and C's section 199A deduction is $14,400 for 2018.

(vii) *Example 7*. (A) F, an unmarried individual, owns as a sole proprietor 100 percent of three trades or businesses, Business X, Business Y, and Business Z. None of the businesses hold qualified property. F does not aggregate the trades or businesses under § 1.199A–4. For taxable year 2018, Business X generates $1 million of QBI and pays $500,000 of W–2 wages with respect to the business. Business Y also generates $1 million of QBI but pays no wages. Business Z generates $2,000 of QBI and pays $500,000 of W–2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $2,722,000.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. Because QBI from each business is positive, F applies the limitation by determining the lesser of 20% of QBI and 50% of W–2 wages for each business.For Business X, the lesser of 20% of QBI ($1,000,000 × 20 percent = $200,000) and 50% of Business X's W–2 wages ($500,000 × 50% = $250,000) is $200,000. Business Y pays no W–2 wages. The lesser of 20% of Business Y's QBI($1,000,000 × 20% = $200,000) and 50% of its W–2 wages (zero) is zero. For Business Z, the lesser of 20% of QBI ($2,000 × 20% = $400) and 50% of W–2 wages ($500,000 × 50% = $250,000) is $400.

(C) Next, F must then combine the amounts determined in paragraph (d)(4)(vii)(B) of this section and compare that sum to 20% of F's taxable income. The lesser of these two amounts equals F's section 199A deduction. The total of the combined amounts in paragraph (d)(4)(vii)(B) of this section is $200,400 ($200,000 + zero + 400). Twenty percent of F's taxable income is $544,400 ($2,722,000 × 20%). Thus, F's section 199A deduction for 2018 is $200,400.

(viii) *Example 8*. (A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A–4.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W–2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses, which is $400,400 ($2,002,000 × 20%) and 50% of W–2 wages from the aggregated businesses, which is $500,000 ($1,000,000 x 50%). F's section 199A deduction is equal to the lesser of $400,400 and 20% of F's taxable income ($2,722,000 × 20% = $544,400). Thus, F's section 199A deduction for 2018 is $400,400.

(ix) *Example 9*. (A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that for taxable year 2018, Business Z generates a loss that results in ($600,000) of negative QBI and pays $500,000 of W–2 wages. After allowable deductions unrelated to the businesses, F's taxable income is $2,120,000. Because Business Z had negative QBI, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X and Business Y produced the same amount of positive QBI, the negative QBI from Business Z is apportioned equally among Business X and Business Y. Therefore, the adjusted QBI for each of Business X and Business Y is $700,000 ($1 million plus 50% of the negative QBI of $600,000). The adjusted QBI in Business Z is $0, because its negative QBI has been fully apportioned to Business X and Business Y.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For

Business X, the lesser of 20% of QBI ($700,000 × 20% = $140,000) and 50% of W–2 wages ($500,000 × 50% = $250,000) is $140,000. Business Y pays no W–2 wages. The lesser of 20% of Business Y's QBI ($700,000 × 20% = $140,000) and 50% of its W–2 wages (zero) is zero.

(C) F must combine the amounts determined in paragraph (d)(4)(ix)(B) of this section and compare the sum to 20% of taxable income. F's section 199A deduction equals the lesser of these two amounts. The combined amount from paragraph (d)(4)(ix)(B) of this section is $140,000 ($140,000 + zero) and 20% of F's taxable income is $424,000 ($2,120,000 × 20%). Thus, F's section 199A deduction for 2018 is $140,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

(x) *Example 10.* (A) Assume the same facts as in *Example 9* of paragraph (d)(4)(ix) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of §1.199A–4.

(B) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. Because the businesses are aggregated, these limitations are applied on an aggregated basis. None of the businesses holds qualified property, therefore only the W–2 wage limitation must be calculated. F applies the limitation by determining the lesser of 20% of the QBI from the aggregated businesses ($1,400,000 × 20% = $280,000) and 50% of W–2 wages from the aggregated businesses ($1,000,000 × 50% = $500,000), or $280,000. F's section 199A deduction is equal to the lesser of $280,000 and 20% of F's taxable income ($2,120,000 × 20% = $424,000). Thus, F's section 199A deduction for 2018 is $280,000. There is no carryover of any loss into the following taxable year for purposes of section 199A.

(xi) *Example 11.* (A) Assume the same facts as in *Example 7* of paragraph (d)(4)(vii) of this section, except that Business Z generates a loss that results in ($2,150,000) of negative QBI and pays $500,000 of W–2 wages with respect to the business in 2018. Thus, F has a negative combined QBI of ($150,000) when the QBI from all of the businesses are added together ($1 million plus $1 million minus the loss of ($2,150,000)). Because F has a negative combined QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. None of the W–2 wages carry forward. However, for income tax purposes, the $150,000 loss may offset F's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, Business X generates $200,000 of net QBI and pays $100,000 of W–2 wages with respect to the business. Business Y generates $150,000 of net QBI but pays no wages. Business Z generates a loss that results in ($120,000) of negative QBI and pays $500 of W–2 wages with respect to the business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. Pursuant to paragraph (d)(2)(iii)(B) of this section, the ($150,000) of negative QBI from 2018 is treated as arising in 2019 from a separate trade or business. Thus, F has overall net QBI of $80,000 when all trades or businesses are taken together ($200,000) plus $150,000 minus $120,000 minus the carryover loss of ($150,000). Because Business Z had negative QBI and F also has a negative QBI carryover amount, F must offset the positive QBI from Business X and Business Y with the negative QBI from Business Z and the carryover amount in proportion to the relative amounts of positive QBI from Business X and Business Y. Because Business X produced 57.14% of the total QBI from Business X and Business Y, 57.14% of the negative QBI from Business Z and the negative QBI carryforward must be apportioned to Business X, and the remaining 42.86% allocated to Business Y. Therefore, the adjusted QBI in Business X is $45,722 ($200,000 minus 57.14% of the loss from Business Z ($68,568), minus 57.14% of the carryover loss ($85,710). The adjusted QBI in Business Y is $34,278 ($150,000, minus 42.86% of the loss from

Business Z ($51,432) minus 42.86% of the carryover loss ($64,290)). The adjusted QBI in Business Z is $0, because its negative QBI has been apportioned to Business X and Business Y.

(C) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For Business X, 20% of QBI is $9,144 ($45,722 × 20%) and 50% of W–2 wages is $50,000 ($100,000 × 50%), so the lesser amount is $9,144. Business Y pays no W–2 wages. Twenty percent of Business Y's QBI is $6,856 ($34,278 × 20%) and 50% of its W–2 wages (zero) is zero, so the lesser amount is zero.

(D) F must then compare the combined amounts determined in paragraph (d)(4)(xi)(C) of this section to 20% of F's taxable income. The section 199A deduction equals the lesser of these amounts. F's combined amount from paragraph (d)(4)(xi)(C) of this section is $9,144 ($9,144 plus zero) and 20% of F's taxable income is $192,000 ($960,000 × 20%) Thus, F's section 199A deduction for 2019 is $9,144. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

(xii) *Example 12*. (A) Assume the same facts as in *Example 11* of paragraph (d)(4)(xi) of this section, except that F aggregates Business X, Business Y, and Business Z under the rules of § 1.199A–4. For 2018, F's QBI from the aggregated trade or business is ($150,000). Because F has a combined negative QBI for 2018, F has no section 199A deduction with respect to any trade or business for 2018. Instead, the negative combined QBI of ($150,000) carries forward and will be treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next taxable year. However, for income tax purposes, the $150,000 loss may offset taxpayer's $750,000 of wage income (assuming the loss is otherwise allowable under the Code).

(B) In taxable year 2019, F will have QBI of $230,000 and W–2 wages of $100,500 from the aggregated trade or business. F also has $750,000 of wage income from employment with an unrelated company. After allowable deductions unrelated to the businesses, F's taxable income is $960,000. F must treat the negative QBI carryover loss ($150,000) from 2018 as a loss from a separate trade or business for purposes of section 199A. This loss will offset the positive QBI from the aggregated trade or business, resulting in an adjusted QBI of $80,000 ($230,000 − $150,000).

(C) Because F's taxable income is above the threshold amount, the QBI component of F's section 199A deduction is subject to the W–2 wage and UBIA of qualified property limitations. These limitations must be applied on a business-by-business basis. None of the businesses hold qualified property, therefore only the 50% of W–2 wage limitation must be calculated. For the aggregated trade or business, the lesser of 20% of QBI ($80,000 × 20% = $16,000) and 50% of W–2 wages ($100,500 × 50% = $50,250) is $16,000. F's section 199A deduction equals the lesser of that amount ($16,000) and 20% of F's taxable income ($960,000 × 20% = $192,000). Thus, F's section 199A deduction for 2019 is $16,000. There is no carryover of any negative QBI into the following taxable year for purposes of section 199A.

(e) *Special rules*—(1) *Effect of deduction*. In the case of a partnership or S corporation, section 199A is applied at the partner or shareholder level. The rules of subchapter K and subchapter S of the Code apply in their entirety for purposes of determining each partner's or shareholder's share of QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income or loss. The section 199A deduction has no effect on the adjusted basis of a partner's interest in the partnership, the adjusted basis of a shareholder's stock in an S corporation, or an S corporation's accumulated adjustments account.

(2) *Disregarded entities*. An entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Code is disregarded for purposes of section 199A and §§ 1.199A–1 through 1.199A–6.

(3) *Self-employment tax and net investment income tax*. The deduction allowed

under section 199A does not reduce net earnings from self-employment under section 1402 or net investment income under section 1411.

(4) *Commonwealth of Puerto Rico*. If all of an individual's QBI from sources within the Commonwealth of Puerto Rico is taxable under section 1 of the Code for a taxable year, then for purposes of determining the QBI of such individual for such taxable year, the term ''United States'' includes the Commonwealth of Puerto Rico.

(5) *Coordination with alternative minimum tax*. For purposes of determining alternative minimum taxable income under section 55, the deduction allowed under section 199A(a) for a taxable year is equal in amount to the deduction allowed under section 199A(a) in determining taxable income for that taxable year (that is, without regard to any adjustments under sections 56 through 59).

(6) *Imposition of accuracy-related penalty on underpayments*. For rules related to the imposition of the accuracy-related penalty on underpayments for taxpayers who claim the deduction allowed under section 199A, see section 6662(d)(1)(C).

(7) *Reduction for income received from cooperatives*. In the case of any trade or business of a patron of a *specified agricultural or horticultural cooperative*, as defined in section 199A(g)(4), the amount of section 199A deduction determined under paragraph (c) or (d) of this section with respect to such trade or business must be reduced by the lesser of:

(i) Nine percent of the QBI with respect to such trade or business as is properly allocable to qualified payments received from such cooperative; or

(ii) 50 percent of the W–2 wages with respect to such trade or business as are so allocable as determined under § 1.199A–2.

(f) *Applicability date*—(1) *General rule*. Except as provided in paragraph (f)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exception for non-calendar year RPE*. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

[T.D. 9847, 84 FR 2989, Feb. 8, 2019, as amended by T.D. 9847, 84 FR 15954, Apr. 17, 2019]

§ 1.199A–2 Determination of W–2 wages and unadjusted basis immediately after acquisition of qualified property.

(a) *Scope*—(1) *In general*. This section provides guidance on calculating a trade or business's W–2 wages properly allocable to QBI (W–2 wages) and the trade or business's unadjusted basis immediately after acquisition of all qualified property (UBIA of qualified property). The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) *W–2 wages*. Paragraph (b) of this section provides guidance on the determination of W–2 wages. The determination of W–2 wages must be made for each trade or business by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). In the case of W–2 wages paid by an RPE, the RPE must determine and report W–2 wages for each trade or business (or aggregated trade or business) conducted by the RPE. W–2 wages are presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(3) *UBIA of qualified property*—(i) *In general*. Paragraph (c) of this section provides guidance on the determination of the UBIA of qualified property. The determination of the UBIA of qualified property must be made for each trade or business (or aggregated trade or business) by the individual or RPE that directly conducts the trade or business (or aggregated trade or business). The UBIA of qualified property is presumed to be zero if not determined and reported for each trade or business (or aggregated trade or business).

(ii) *UBIA of qualified property held by a partnership.* In the case of qualified property held by a partnership, each partner's share of the UBIA of qualified property is determined in accordance with how the partnership would allocate depreciation under §1.704–1(b)(2)(iv)(*g*) on the last day of the taxable year.

(iii) *UBIA of qualified property held by an S corporation.* In the case of qualified property held by an S corporation, each shareholder's share of the UBIA of qualified property is the share of the unadjusted basis proportionate to the ratio of shares in the S corporation held by the shareholder on the last day of the taxable year over the total issued and outstanding shares of the S corporation.

(iv) *UBIA and section 743(b) basis adjustments*—(A) *In general.* A partner will be allowed to take into account UBIA with respect to an item of qualified property in addition to the amount of UBIA with respect to such qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated to such partner under paragraph (a)(3)(ii) of this section to the extent of the partner's excess section 743(b) basis adjustment with respect to such item of qualified property.

(B) *Excess section 743(b) basis adjustments.* A partner's *excess section 743(b) basis adjustment* is an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§1.743–1(b) and 1.755–1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property. The absolute value of the excess section 743(b) basis adjustment cannot exceed the absolute value of the total section 743(b) basis adjustment with respect to qualified property.

(C) *Computation of partner's share of UBIA with excess section 743(b) basis adjustments.* The partnership first computes its UBIA with respect to qualified property under paragraphs (a)(3)(i) and (c) of this section and allocates such UBIA under paragraph (a)(3)(ii) of this section. If the sum of the excess section 743(b) basis adjustment for all of the items of qualified property is a negative number, that amount will be subtracted from the partner's UBIA of qualified property determined under paragraphs (a)(3)(i) and (c) of this section and allocated under paragraph (a)(3)(ii) of this section. A partner's UBIA of qualified property may not be below $0. Excess section 743(b) basis adjustments are computed with respect to all section 743(b) adjustments, including adjustments made as a result of a substantial built-in loss under section 743(d).

(D) *Examples.* The provisions of this paragraph (a)(3)(iv) are illustrated by the following examples:

(*1*) *Example 1*—(*i*) *Facts.* A, B, and C are equal partners in partnership, PRS. PRS has a single trade or business that generates QBI. PRS has no liabilities and only one asset, a single item of qualified property with a UBIA equal to $900,000. Each partner's share of the UBIA is $300,000. A sells its one-third interest in PRS to T for $350,000 when a section 754 election is in effect. At the time of the sale, the tax basis of the qualified property held by PRS is $750,000. The amount of gain that would be allocated to T from a hypothetical transaction under §1.743–1(d)(2) is $100,000. Thus, T's interest in PRS's previously taxed capital is equal to $250,000 ($350,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $100,000, T's share of gain from the hypothetical transaction). The amount of T's section 743(b) basis adjustment to PRS's qualified property is $100,000 (the excess of $350,000, T's cost basis for its interest, over $250,000, T's share of the adjusted basis to PRS of the partnership's property).

(*ii*) [Reserved]

(*iii*) *Analysis.* In order for T to determine its UBIA, T must calculate its excess section 743(b) basis adjustment. T's excess section 743(b) basis adjustment is equal to an amount that would represent T's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§1.743–1(b) and 1.755–1, but calculated as if the adjusted basis of all of PRS's property was equal to the UBIA of such property. T's section 743(b) basis adjustment calculated as if adjusted basis of the qualified property were equal to its UBIA is $50,000 (the excess of $350,000, T's cost basis for its interest, over $300,000, T's share of the adjusted basis to PRS of the partnership's property). Thus, T's excess section 743(b) basis adjustment is equal to $50,000. For purposes of applying the UBIA limitation to T's share of QBI from PRS's trade or business, T's UBIA is equal to $350,000 ($300,000, T's one-third share of the qualified property's UBIA, plus $50,000, T's excess section 743(b) basis adjustment).

(*2*) *Example 2*—(*i*) *Facts.* Assume the same facts as in *Example 1* of paragraph (a)(3)(iv)(D)(*1*) of this section, except that A sells its one-third interest in PRS to T for $200,000 when a section 754 election is in effect. At the time of the sale, the tax basis of the qualified property held by PRS is $750,000, and the amount of loss that would be allocated to T from a hypothetical transaction under § 1.743–1(d)(2) is $50,000. Thus, T's interest in PRS's previously taxed capital is equal to $250,000 ($200,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, increased by $50,000, T's share of loss from the hypothetical transaction). The amount of T's section 743(b) basis adjustment to PRS's qualified property is negative $50,000 (the excess of $250,000, T's share of the adjusted basis to PRS of the partnership's property, over $200,000, T's cost basis for its interest).

(*ii*) *Analysis.* In order for T to determine its UBIA, T must calculate its excess section 743(b) basis adjustment. T's excess section 743(b) basis adjustment is equal to an amount that would represent T's section 743(b) basis adjustment with respect to the same item of qualified property, as determined under §§ 1.743–1(b) and 1.755–1, but calculated as if the adjusted basis of all of PRS's property was equal to the UBIA of such property. T's section 743(b) basis adjustment calculated as if adjusted basis of the qualified property were equal to its UBIA is negative $100,000 (the excess of $300,000, T's share of the adjusted basis to PRS of the partnership's property, over $200,000, T's cost basis for its interest). T's excess section 743(b) basis adjustment to the qualified property is limited to the amount of T's section 743(b) basis adjustment of negative $50,000. Thus, T's excess section 743(b) basis adjustment is equal to negative $50,000. For purposes of applying the UBIA limitation to T's share of QBI from PRS's trade or business, T's UBIA is equal to $250,000 ($300,000, T's one-third share of the qualified property's UBIA, reduced by T's negative $50,000 excess section 743(b) basis adjustment).

(b) *W–2 wages*—(1) *In general.* Section 199A(b)(2)(B) provides limitations on the section 199A deduction based on the W–2 wages paid with respect to each trade or business (or aggregated trade or business). Section 199A(b)(4)(B) provides that W–2 wages do not include any amount which is not properly allocable to QBI for purposes of section 199A(c)(1). This section provides a three step process for determining the W–2 wages paid with respect to a trade or business that are properly allocable to QBI. First, each individual or RPE must determine its total W–2 wages paid for the taxable year under the rules in paragraph (b)(2) of this section. Second, each individual or RPE must allocate its W–2 wages between or among one or more trades or businesses under the rules in paragraph (b)(3) of this section. Third, each individual or RPE must determine the amount of such wages with respect to each trade or business, which are allocable to the QBI of the trade or business (or aggregated trade or business) under the rules in paragraph (b)(4) of this section.

(2) *Definition of W–2 wages*—(i) *In general.* Section 199A(b)(4)(A) provides that the term W–2 wages means with respect to any person for any taxable year of such person, the amounts described in section 6051(a)(3) and (8) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W–2 wages includes the total amount of wages as defined in section 3401(a) plus the total amount of elective deferrals (within the meaning of section 402(g)(3)), the compensation deferred under section 457, and the amount of designated Roth contributions (as defined in section

402A). For this purpose, except as provided in paragraphs (b)(2)(iv)(C)(*2*) and (b)(2)(iv)(D) of this section, the Forms W–2, ''Wage and Tax Statement,'' or any subsequent form or document used in determining the amount of W–2 wages, are those issued for the calendar year ending during the individual's or RPE's taxable year for wages paid to employees (or former employees) of the individual or RPE for employment by the individual or RPE. For purposes of this section, employees of the individual or RPE are limited to employees of the individual or RPE as defined in section 3121(d)(1) and (2). (For purposes of section 199A, this includes officers of an S corporation and employees of an individual or RPE under common law.)

(ii) *Wages paid by a person other than a common law employer.* In determining W–2 wages, an individual or RPE may take into account any W–2 wages paid by another person and reported by the other person on Forms W–2 with the other person as the employer listed in Box c of the Forms W–2, provided that the W–2 wages were paid to common law employees or officers of the individual or RPE for employment by the individual or RPE. In such cases, the person paying the W–2 wages and reporting the W–2 wages on Forms W–2 is precluded from taking into account such wages for purposes of determining W–2 wages with respect to that person. For purposes of this paragraph (b)(2)(ii), persons that pay and report W–2 wages on behalf of or with respect to others can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(iii) *Requirement that wages must be reported on return filed with the Social Security Administration (SSA)*—(A) *In general.* Pursuant to section 199A(b)(4)(C), the term W–2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051–2 of this chapter, each Form W–2 and the transmittal Form W–3, ''Transmittal of Wage and Tax Statements,'' together constitute an information return to be filed with SSA. Similarly, each Form W–2c, ''Corrected Wage and Tax Statement,'' and the transmittal Form W–3 or W–3c, ''Transmittal of Corrected Wage and Tax Statements,'' together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W–2 together with its accompanying Form W–3 will be considered a separate information return and each Form W–2c together with its accompanying Form W–3 or Form W–3c will be considered a separate information return. Section 6071(c) provides that Forms W–2 and W–3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a)–1T(a)(3)(i) of this chapter for monthly returns filed under §31.6011(a)–5(a) of this chapter). Corrected Forms W–2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(B) *Corrected return filed to correct a return that was filed within 60 days of the due date.* If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (b)(2)(iii)(C) of this section does not apply, then the wage information on Return B must be included in determining W–2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), and if Return D reports an increase (or increases) in wages included in determining W–2 wages from the wage amounts reported on Return C, then such increase (or increases) on Return D will be disregarded in determining W–2 wages (and only the wage amounts on Return C may be included in determining W–2 wages). If Return D reports a decrease (or decreases) in wages included in determining W–2 wages from the amounts reported on Return C, then, in determining W–2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(C) *Corrected return filed to correct a return that was filed later than 60 days after the due date*. If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W–2c is filed to correct a Form W–2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2 (or to correct a Form W–2c relating to Form W–2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2), then this Form W–2c will not be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W–2c (or corrected Form W–2), regardless of when the Form W–2c is filed.

(iv) *Methods for calculating W–2 wages*—(A) *In general*. The Secretary may provide for methods to be used in calculating W–2 wages, including W–2 wages for short taxable years by publication in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter).

(B) *Acquisition or disposition of a trade or business*—(*1*) *In general*. In the case of an acquisition or disposition of a trade or business, the major portion of a trade or business, or the major portion of a separate unit of a trade or business that causes more than one individual or entity to be an employer of the employees of the acquired or disposed of trade or business during the calendar year, the W–2 wages of the individual or entity for the calendar year of the acquisition or disposition are allocated between each individual or entity based on the period during which the employees of the acquired or disposed of trade or business were employed by the individual or entity, regardless of which permissible method is used for reporting predecessor and successor wages on Form W–2, ''Wage and Tax Statement.'' For this purpose, the period of employment is determined consistently with the principles for determining whether an individual is an employee described in paragraph (b) of this section.

(*2*) *Acquisition or disposition*. For purposes of this paragraph (b)(2)(iv)(B), the term *acquisition or disposition* includes an incorporation, a formation, a liquidation, a reorganization, or a purchase or sale of assets.

(C) *Application in the case of a person with a short taxable year*—(*1*) *In general*. In the case of an individual or RPE with a short taxable year, subject to the rules of paragraph (b)(2) of this section, the W–2 wages of the individual or RPE for the short taxable year include only those wages paid during the short taxable year to employees of the individuals or RPE, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the individual or RPE and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the individual or RPE.

(*2*) *Short taxable year that does not include December 31*. If an individual or RPE has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by such individual or RPE during the short taxable year are treated as W–2 wages for such short taxable year for purposes of paragraph (b) of this section (if the wages would otherwise meet the requirements to be W–2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(D) *Remuneration paid for services performed in the Commonwealth of Puerto Rico*. In the case of an individual or RPE that conducts a trade or business in the Commonwealth of Puerto Rico, the determination of W–2 wages of such individual or RPE will be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services performed in the Commonwealth of Puerto Rico. The individual or RPE must maintain sufficient documentation (for example, Forms 499R–2/W–2PR) to substantiate the amount of remuneration paid for services performed in the Commonwealth of Puerto Rico that is used in determining the W–2 wages of such individual or RPE with respect to any trade or business conducted in the Commonwealth of Puerto Rico.

(3) *Allocation of wages to trades or businesses.* After calculating total W–2 wages for a taxable year, each individual or RPE that directly conducts more than one trade or business must allocate those wages among its various trades or businesses. W–2 wages must be allocated to the trade or business that generated those wages. In the case of W–2 wages that are allocable to more than one trade or business, the portion of the W–2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under § 1.199A–3(b)(5).

(4) *Allocation of wages to QBI.* Once W–2 wages for each trade or business have been determined, each individual or RPE must identify the amount of W–2 wages properly allocable to QBI for each trade or business (or aggregated trade or business). W–2 wages are properly allocable to QBI if the associated wage expense is taken into account in computing QBI under § 1.199A–3. In the case of an RPE, the wage expense must be allocated and reported to the partners or shareholders of the RPE as required by the Code, including subchapters K and S of chapter 1 of subtitle A of the Code. The RPE must also identify and report the associated W–2 wages to its partners or shareholders.

(5) *Non-duplication rule.* Amounts that are treated as W–2 wages for a taxable year under any method cannot be treated as W–2 wages of any other taxable year. Also, an amount cannot be treated as W–2 wages by more than one trade or business (or aggregated trade or business).

(c) *UBIA of qualified property*—(1) *Qualified property*—(i) *In general.* The term *qualified property* means, with respect to any trade or business (or aggregated trade or business) of an individual or RPE for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167(a)—

(A) Which is held by, and available for use in, the trade or business (or aggregated trade or business) at the close of the taxable year;

(B) Which is used at any point during the taxable year in the trade or business's (or aggregated trade or business's) production of QBI; and

(C) The depreciable period for which has not ended before the close of the individual's or RPE's taxable year.

(ii) *Improvements to qualified property.* In the case of any addition to, or improvement of, qualified property that has already been placed in service by the individual or RPE, such addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service for purposes of paragraph (c)(2) of this section.

(iii) *Adjustments under sections 734(b) and 743(b).* Excess section 743(b) basis adjustments as defined in paragraph (a)(3)(iv)(B) of this section are treated as qualified property. Otherwise, basis adjustments under sections 734(b) and 743(b) are not treated as qualified property.

(iv) *Property acquired at end of year.* Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days of acquisition without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the section 199A deduction.

(2) *Depreciable period*—(i) *In general.* The term *depreciable period* means, with respect to qualified property of a trade or business, the period beginning on the date the property was first placed in service by the individual or RPE and ending on the later of—

(A) The date that is 10 years after such date; or

(B) The last day of the last full year in the applicable recovery period that would apply to the property under section 168(c), regardless of any application of section 168(g).

(ii) *Additional first-year depreciation under section 168.* The additional first-year depreciation deduction allowable under section 168 (for example, under section 168(k) or (m)) does not affect the applicable recovery period under this paragraph for the qualified property.

(iii) *Qualified property acquired in transactions subject to section 1031 or section 1033.* Solely for purposes of paragraph (c)(2)(i) of this section, the following rules apply to qualified property acquired in a like-kind exchange or in an involuntary conversion (replacement property).

(A) *Replacement property received in a section 1031 or 1033 transaction.* The date on which replacement property that is of like-kind to relinquished property or is similar or related in service or use to involuntarily converted property was first placed in service by the individual or RPE is determined as follows—

(*1*) For the portion of the individual's or RPE's UBIA, as defined in paragraph (c)(3) of this section, in such replacement property that does not exceed the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, the date such portion in the replacement property was first placed in service by the individual or RPE is the date on which the relinquished property or involuntarily converted property was first placed in service by the individual or RPE; and

(*2*) For the portion of the individual's or RPE's UBIA, as defined in paragraph (c)(3) of this section, in such replacement property that exceeds the individual's or RPE's UBIA in the relinquished property or involuntarily converted property, such portion in the replacement property is treated as separate qualified property that the individual or RPE first placed in service on the date on which the replacement property was first placed in service by the individual or RPE.

(B) *Other property received in a section 1031 or 1033 transaction.* Other property, as defined in paragraph (c)(3)(ii) or (iii) of this section, that is qualified property is treated as separate qualified property that the individual or RPE first placed in service on the date on which such other property was first placed in service by the individual or RPE.

(iv) *Qualified property acquired in transactions described in section 168(i)(7)(B).* If an individual or RPE acquires qualified property in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the individual or RPE must determine the date on which the qualified property was first placed in service solely for purposes of paragraph (c)(2)(i) of this section as follows—

(A) For the portion of the transferee's UBIA in the qualified property that does not exceed the transferor's UBIA in such property, the date such portion was first placed in service by the transferee is the date on which the transferor first placed the qualified property in service; and

(B) For the portion of the transferee's UBIA in the qualified property that exceeds the transferor's UBIA in such property, such portion is treated as separate qualified property that the transferee first placed in service on the date of the transfer.

(v) *Excess section 743(b) basis adjustment.* Solely for purposes of paragraph (c)(2)(i) of this section, an excess section 743(b) basis adjustment with respect to an item of partnership property that is qualified property is treated as being placed in service when the transfer of the partnership interest occurs, and the recovery period for such property is determined under §1.743–1(j)(4)(i)(B) with respect to positive basis adjustments and §1.743–1(j)(4)(ii)(B) with respect to negative basis adjustments.

(3) *Unadjusted basis immediately after acquisition*—(i) *In general.* Except as provided in paragraphs (c)(3)(ii) through (v) of this section, the term *unadjusted basis immediately after acquisition* (UBIA) means the basis on the placed in service date of the property as determined under section 1012 or other applicable sections of chapter 1 of the Code, including the provisions of subchapters O (relating to gain or loss on dispositions of property), C (relating

to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). UBIA is determined without regard to any adjustments described in section 1016(a)(2) or (3), to any adjustments for tax credits claimed by the individual or RPE (for example, under section 50(c)), or to any adjustments for any portion of the basis which the individual or RPE has elected to treat as an expense (for example, under sections 179, 179B, or 179C). However, UBIA does reflect the reduction in basis for the percentage of the individual's or RPE's use of property for the taxable year other than in the trade or business.

(ii) *Qualified property acquired in a like-kind exchange*—(A) *In general.* Solely for purposes of this section, if property that is qualified property (replacement property) is acquired in a like-kind exchange that qualifies for deferral of gain or loss under section 1031, then the UBIA of such property is the same as the UBIA of the qualified property exchanged (relinquished property), decreased by excess boot or increased by the amount of money paid or the fair market value of property not of a like kind to the relinquished property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified property as replacement property that is of a like kind to the relinquished property in an exchange described in section 1031, UBIA is apportioned between or among the qualified replacement properties in proportion to their relative fair market values. Other property received by the taxpayer in a section 1031 transaction that is qualified property has a UBIA equal to the fair market value of such other property.

(B) *Excess boot.* For purposes of paragraph (c)(3)(ii)(A) of this section, *excess boot* is the amount of any money or the fair market value of other property received by the taxpayer in the exchange over the amount of appreciation in the relinquished property. Appreciation for this purpose is the excess of the fair market value of the relinquished property on the date of the exchange over the fair market value of the relinquished property on the date of the acquisition by the taxpayer.

(iii) *Qualified property acquired pursuant to an involuntary conversion*—(A) *In general.* Solely for purposes of this section, if qualified property is compulsorily or involuntarily converted (converted property) within the meaning of section 1033 and qualified replacement property is acquired in a transaction that qualifies for deferral of gain under section 1033, then the UBIA of the replacement property is the same as the UBIA of the converted property, decreased by excess boot or increased by the amount of money paid or the fair market value of property not similar or related in service or use to the converted property (other property) transferred by the taxpayer to acquire the replacement property. If the taxpayer acquires more than one piece of qualified replacement property that meets the similar or related in service or use requirements in section 1033, UBIA is apportioned between the qualified replacement properties in proportion to their relative fair market values. Other property acquired by the taxpayer with the proceeds of an involuntary conversion that is qualified property has a UBIA equal to the fair market value of such other property.

(B) *Excess boot.* For purposes of paragraph (c)(3)(iii)(A) of this section, *excess boot* is the amount of any money or the fair market value of other property received by the taxpayer in the conversion over the amount of appreciation in the converted property. Appreciation for this purpose is the excess of the fair market value of the converted property on the date of the conversion over the fair market value of the converted property on the date of the acquisition by the taxpayer.

(iv) *Qualified property acquired in transactions described in section 168(i)(7)(B).* Solely for purposes of this section, if qualified property is acquired in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the transferee's UBIA in the qualified property shall be the same as the transferor's UBIA in the property, decreased by the amount of money received by the transferor in the transaction or increased by the amount of money paid by the transferee to acquire the property in the transaction.

(v) *Qualified property acquired from a decedent*. In the case of qualified property acquired from a decedent and immediately placed in service, the UBIA of the property will generally be the fair market value at the date of the decedent's death under section 1014. See section 1014 and the regulations thereunder. Solely for purposes of paragraph (c)(2)(i) of this section, a new depreciable period for the property commences as of the date of the decedent's death.

(vi) *Property acquired in a nonrecognition transaction with principal purpose of increasing UBIA*. If qualified property is acquired in a transaction described in section 1031, 1033, or 168(i)(7) with the principal purpose of increasing the UBIA of the qualified property, the UBIA of the acquired qualified property is its basis as determined under relevant Code sections and not under the rules described in paragraphs (c)(3)(i) through (iv) of this section. For example, in a section 1031 transaction undertaken with the principal purpose of increasing the UBIA of the replacement property, the UBIA of the replacement property is its basis as determined under section 1031(d).

(4) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

(i) *Example 1*. (A) On January 5, 2012, A purchases Real Property X for $1 million and places it in service in A's trade or business. A's trade or business is not an SSTB. A's basis in Real Property X under section 1012 is $1 million. Real Property X is qualified property within the meaning of section 199A(b)(6). As of December 31, 2018, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $821,550.

(B) For purposes of section 199A(b)(2)(B)(ii) and this section, A's UBIA of Real Property X is its $1 million cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2).

(ii) *Example 2*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031 in which A exchanges Real Property X for Real Property Y. Real Property Y has a value of $1 million. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $820,482.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(iii) *Example 3*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, and Real Property Y also has a value of $1.3 million. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(iv) *Example 4*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million, but Real Property Y has a value of $1.5 million. A therefore adds $200,000 in cash to the exchange of Real Property X for Real Property Y. On January 15, 2019, A places Real Property Y in service. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A's UBIA in Real Property Y is $1.2 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X plus $200,000 cash paid by A to acquire Real Property Y). Because the UBIA of Real Property Y exceeds the UBIA of Real Property X, Real Property Y is treated as being two separate qualified properties for purposes of applying paragraph (c)(2)(iii)(A) of this section. One property has a UBIA of $1 million (the portion of A's UBIA of $1.2 million in Real Property Y that does not exceed A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A. The other property has a UBIA of $200,000 (the portion of A's UBIA of $1.2 million in Real Property Y that exceeds A's UBIA of $1 million in Real Property X) and it is first placed in service by A on January 15, 2019, which is the date on which Real Property Y was first placed in service by A.

(v) *Example 5*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $1 million. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482. Pursuant to the exchange, A receives Real Property Y and $300,000 in cash.

(B) A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X, less $0 excess boot ($300,000 cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(vi) *Example 6*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has appreciated in value to $1.3 million. Real Property Y has a fair market value of $900,000. Pursuant to the exchange, A receives Real Property Y and $400,000 in cash. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) A's UBIA in Real Property Y is $900,000 as determined under paragraph (c)(3)(ii) of this section ($1 million in UBIA from Real Property X less $100,000 excess boot ($400,000 in cash received in the exchange over $300,000 in appreciation in Property X, which is equal to the excess of the $1.3 million fair market value of Property X on the date of the exchange over the $1 million fair market value of Property X on the date of acquisition by the taxpayer)). Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(vii) *Example 7*. (A) The facts are the same as in *Example 1* of paragraph (c)(4)(i) of this section, except that on January 15, 2019, A enters into a like-kind exchange under section 1031, in which A exchanges Real Property X for Real Property Y. Real Property X has declined in value to $900,000, and Real Property Y also has a value of $900,000. No cash or other property is involved in the exchange. As of January 15, 2019, A's basis in Real Property X, as adjusted under section 1016(a)(2), is $820,482.

(B) Even though Real Property Y is worth only $900,000, A's UBIA in Real Property Y is $1 million as determined under paragraph (c)(3)(ii) of this section because no cash or other property was involved in the exchange. Pursuant to paragraph (c)(2)(iii)(A) of this section, Real Property Y is first placed in service by A on January 5, 2012, which is the date on which Real Property X was first placed in service by A.

(viii) *Example 8*. (A) C operates a trade or business that is not an SSTB as a sole proprietorship. On January 5, 2011, C purchases Machinery Y for $10,000 and places it in service in C's trade or business. C's basis in Machinery Y under section 1012 is $10,000. Machinery Y is qualified property within the meaning of section 199A(b)(6). Assume that Machinery Y's recovery period under section 168(c) is 10 years, and C depreciates Machinery Y under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, C's basis in Machinery Y, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $2,500. On January 1, 2019, C incorporates the sole proprietorship and elects to treat the newly formed entity as an S corporation for Federal income tax purposes. C contributes Machinery Y and all other assets of the trade or business to the S corporation in a non-recognition transaction under section 351. The S corporation immediately places all the assets in service.

(B) For purposes of section 199A(b)(2)(B)(ii) and this section, C's UBIA of Machinery Y from 2011 through 2018 is its $10,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). The S corporation's basis of Machinery Y is $2,500, the basis of the property under section 362 at the time the S corporation places the property in service. Pursuant to paragraph (c)(3)(iv) of this section, S corporation's UBIA of Machinery Y is $10,000, which is C's UBIA of Machinery Y. Pursuant to paragraph (c)(2)(iv)(A) of this section, for purposes of determining the depreciable period of Machinery Y, the S corporation's placed in service date of Machinery Y will be January 5, 2011, which is the date C originally placed the property in service in 2011. Therefore, Machinery Y may be qualified property of the S corporation (assuming it continues to be used in the business) for 2019 and 2020 and will not be qualified property of the S corporation after 2020, because its depreciable period will have expired.

(ix) *Example 9*. (A) LLC, a partnership, operates a trade or business that is not an SSTB. On January 5, 2011, LLC purchases Machinery Z for $30,000 and places it in service in LLC's trade or business. LLC's basis in Machinery Z under section 1012 is $30,000. Machinery Z is qualified property within the meaning of section 199A(b)(6). Assume that Machinery Z's recovery period under section 168(c) is 10 years, and LLC depreciates Machinery Z under the general depreciation system by using the straight-line depreciation method, a 10-year recovery period, and the half-year convention. As of December 31, 2018, LLC's basis in Machinery Z, as adjusted under section 1016(a)(2) for depreciation deductions under section 168(a), is $7,500. On January 1, 2019, LLC distributes Machinery Z to Partner A in full liquidation of Partner A's interest in LLC. Partner A's outside basis in LLC is $35,000.

(B) For purposes of section 199A(b)(2)(B)(ii) and this section, LLC's UBIA of Machinery Z from 2011 through 2018 is its $30,000 cost basis under section 1012, regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2). Prior to the distribution to Partner A, LLC's basis of Machinery Z is $7,500. Under section 732(b), Partner A's basis in Machinery Z is $35,000. Pursuant to paragraph (c)(3)(iv) of this section, upon distribution of Machinery Z, Partner A's UBIA of Machinery Z is $30,000, which was LLC's UBIA of Machinery Z.

(d) *Applicability date*—(1) *General rule*. Except as provided in paragraph (d)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exceptions*—(i) *Anti-abuse rules*. The provisions of paragraph (c)(1)(iv) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

[T.D. 9847, 84 FR 2995, Feb. 8, 2019, as amended by T.D. 9847, 84 FR 15954, Apr. 17, 2019]

§ 1.199A–3 Qualified business income, qualified REIT dividends, and qualified PTP income.

(a) *In general.* This section provides rules on the determination of a trade or business's qualified business income (QBI), as well as the determination of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code). Paragraph (b) of this section provides rules for the determination of QBI. Paragraph (c) of this section provides rules for the determination of qualified REIT dividends and qualified PTP income. QBI must be determined and reported for each trade or business by the individual or relevant passthrough entity (RPE) that directly conducts the trade or business before applying the aggregation rules of § 1.199A–4.

(b) *Definition of qualified business income*—(1) *In general.* For purposes of this section, the term *qualified business income* or *QBI* means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business of the taxpayer as described in paragraph (b)(2) of this section, provided the other requirements of this section and section 199A are satisfied (including, for example, the exclusion of income not effectively connected with a United States trade or business).

(i) *Section 751 gain.* With respect to a partnership, if section 751(a) or (b) applies, then gain or loss attributable to assets of the partnership giving rise to ordinary income under section 751(a) or (b) is considered attributable to the trades or businesses conducted by the partnership, and is taken into account for purposes of computing QBI.

(ii) *Guaranteed payments for the use of capital.* Income attributable to a guaranteed payment for the use of capital is not considered to be attributable to a trade or business, and thus is not taken into account for purposes of computing QBI except to the extent properly allocable to a trade or business of the recipient. The partnership's deduction associated with the guaranteed payment will be taken into account for purposes of computing QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(iii) *Section 481 adjustments.* Section 481 adjustments (whether positive or negative) are taken into account for purposes of computing QBI to the extent that the requirements of this section and section 199A are otherwise satisfied, but only if the adjustment arises in taxable years ending after December 31, 2017.

(iv) *Previously disallowed losses*—(A) *In general.* Previously disallowed losses or deductions allowed in the taxable year generally are taken into account for purposes of computing QBI to the extent the disallowed loss or deduction is otherwise allowed by section 199A. These previously disallowed losses include, but are not limited to losses disallowed under sections 461(l), 465, 469, 704(d), and 1366(d). These losses are used for purposes of section 199A and this section in order from the oldest to the most recent on a first-in, first-out (FIFO) basis and are treated as losses from a separate trade or business. To the extent such losses relate to a PTP, they must be treated as a loss from a separate PTP in the taxable year the losses are taken into account. However, losses or deductions that were disallowed, suspended, limited, or carried over from taxable years ending before January 1, 2018 (including under sections 465, 469, 704(d), and 1366(d)), are not taken into account in a subsequent taxable year for purposes of computing QBI.

(B) *Partial allowance.* If a loss or deduction attributable to a trade or business is only partially allowed during the taxable year in which incurred, only the portion of the allowed loss or deduction that is attributable to QBI will be considered in determining QBI from the trade or business in the year the loss or deduction is incurred. The portion of the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction, the numerator of which is the portion of the total loss incurred during the taxable year that is attributable to QBI and the denominator of which is the amount of the total loss incurred during the taxable year.

(C) *Attributes of disallowed loss or deduction determined in year loss is incurred*—(*1*) *In general.* Whether a disallowed loss or deduction is attributable to a trade or business, and otherwise meets the requirements of this section, is determined in the year the loss is incurred.

(*2*) *Specified service trades or businesses.* If a disallowed loss or deduction is attributable to a specified service trade or business (SSTB), whether an individual has taxable income at or below the threshold amount as defined in §1.199A–1(b)(12), within the phase-in range as defined in §1.199A–1(b)(4), or in excess of the phase-in range is determined in the year the loss or deduction is incurred. If the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, the entire disallowed loss or deduction must be taken into account when applying paragraph (b)(1)(iv)(A) of this section. If the individual's taxable income is within the phase-in range, then only the applicable percentage, as defined in §1.199A–1(b)(2), of the disallowed loss or deduction is taken into account when applying paragraph (b)(1)(iv)(A) of this section. If the individual's taxable income exceeds the phase-in range, none of the disallowed loss or deduction will be taken into account in applying paragraph (b)(1)(iv)(A) of this section.

(D) *Examples.* The following examples illustrate the provisions of this paragraph (b)(1)(iv).

(*1*) *Example 1.* A is an unmarried individual and a 50% owner of LLC, an entity classified as a partnership for Federal income tax purposes. In 2018, A's allocable share of loss from LLC is $100,000 of which $80,000 is negative QBI. Under section 465, $60,000 of the allocable loss is allowed in determining A's taxable income. A has no other previously disallowed losses under section 465 or any other provision of the Code for 2018 or prior years. Because 80% of A's allocable loss is attributable to QBI ($80,000/$100,000), A will reduce the amount A takes into account in determining QBI proportionately. Thus, A will include $48,000 of the allowed loss in negative QBI (80% of $60,000) in determining A's section 199A deduction in 2018. The remaining $32,000 of negative QBI is treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the year the loss is taken into account in determining taxable income as described in §1.199A–1(d)(2)(iii).

(*2*) *Example 2.* B is an unmarried individual and a 50% owner of LLC, an entity classified as a partnership for Federal income tax purposes. After allowable deductions other than the section 199A deduction, B's taxable income for 2018 is $177,500. In 2018, LLC has a single trade or business that is an SSTB. B's allocable share of loss is $100,000, all of which is suspended under section 465. B's allocable share of negative QBI is also $100,000. B has no other previously disallowed losses under section 465 or any other provision of the Code for 2018 or prior years. Because the entire loss is suspended, none of the negative QBI is taken into account in determining B's section 199A deduction for 2018. Further, because the negative QBI is from an SSTB and B's taxable income before the section 199A deduction is within the phase-in range, B must determine the applicable percentage of the negative QBI that must be taken into account in the year that the loss is taken into account in determining taxable income. B's applicable percentage is 100% reduced by 40% (the percentage equal to the amount that B's taxable income for the taxable year exceeds B's threshold amount ($20,000 = $177,500 − $157,500) over $50,000). Thus, B's applicable percentage is 60%. Therefore, B will have $60,000 (60% of $100,000) of negative QBI from a separate trade or business to be applied proportionately to QBI in the year(s) the loss is taken into account in determining taxable income, regardless of the amount of taxable income and how rules under §1.199A–5 apply in the year the loss is taken into account in determining taxable income.

(v) *Net operating losses.* Generally, a net operating loss deduction under section 172 is not considered with respect to a trade or business and therefore, is not taken into account in computing QBI. However, an excess business loss under section 461(l) is treated as a net operating loss carryover to the following taxable year and is taken into account for purposes of computing QBI in the subsequent taxable year in which it is deducted.

(vi) *Other deductions.* Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section

199A and this section are otherwise satisfied. For purposes of section 199A only, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.

(2) *Qualified items of income, gain, deduction, and loss*—(i) *In general*. The term *qualified items of income, gain, deduction, and loss* means items of gross income, gain, deduction, and loss to the extent such items are—

(A) Effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting ''trade or business (within the meaning of section 199A)'' for ''nonresident alien individual or a foreign corporation'' or for ''a foreign corporation'' each place it appears); and

(B) Included or allowed in determining taxable income for the taxable year.

(ii) *Items not taken into account*. Notwithstanding paragraph (b)(2)(i) of this section and in accordance with section 199A(c)(3)(B) and (c)(4), the following items are not taken into account as qualified items of income, gain, deduction, or loss and thus are not included in determining QBI:

(A) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item treated as one of such items under any other provision of the Code. This provision does not apply to the extent an item is treated as anything other than short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

(B) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G). Any amount described in section 1385(a)(1) is not treated as described in this clause.

(C) Any interest income other than interest income which is properly allocable to a trade or business. For purposes of section 199A and this section, interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.

(D) Any item of gain or loss described in section 954(c)(1)(C) (transactions in commodities) or section 954(c)(1)(D) (excess foreign currency gains) applied in each case by substituting ''trade or business (within the meaning of section 199A)'' for ''controlled foreign corporation.''

(E) Any item of income, gain, deduction, or loss described in section 954(c)(1)(F) (income from notional principal contracts) determined without regard to section 954(c)(1)(F)(ii) and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7).

(F) Any amount received from an annuity which is not received in connection with the trade or business.

(G) Any qualified REIT dividends as defined in paragraph (c)(2) of this section or qualified PTP income as defined in paragraph (c)(3) of this section.

(H) Reasonable compensation received by a shareholder from an S corporation. However, the S corporation's deduction for such reasonable compensation will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(I) Any guaranteed payment described in section 707(c) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such guaranteed payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(J) Any payment described in section 707(a) received by a partner for services rendered with respect to the trade or business, regardless of whether the partner is an individual or an RPE. However, the partnership's deduction for such payment will reduce QBI if such deduction is properly allocable to the trade or business and is otherwise deductible for Federal income tax purposes.

(3) *Commonwealth of Puerto Rico.* For the purposes of determining QBI, the term *United States* includes the Commonwealth of Puerto Rico in the case of any taxpayer with QBI for any taxable year from sources within the Commonwealth of Puerto Rico, if all of such receipts are taxable under section 1 for such taxable year. This paragraph (b)(3) only applies as provided in section 199A(f)(1)(C).

(4) *Wages.* Expenses for all wages paid (or incurred in the case of an accrual method taxpayer) must be taken into account in computing QBI (if the requirements of this section and section 199A are satisfied) regardless of the application of the W–2 wage limitation described in §1.199A–1(d)(2)(iv).

(5) *Allocation of items among directly-conducted trades or businesses.* If an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses to which they are attributable using a reasonable method based on all the facts and circumstances. The individual or RPE may use a different reasonable method with respect to different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (b)(5).

(c) *Qualified REIT Dividends and Qualified PTP Income*—(1) *In general.* Qualified REIT dividends and qualified PTP income are the sum of qualified REIT dividends as defined in paragraph (c)(2) of this section earned directly or through an RPE and the net amount of qualified PTP income as defined in paragraph (c)(3) of this section earned directly or through an RPE.

(2) *Qualified REIT dividend*—(i) The term *qualified REIT dividend* means any dividend from a REIT received during the taxable year which—

(A) Is not a capital gain dividend, as defined in section 857(b)(3); and

(B) Is not qualified dividend income, as defined in section 1(h)(11).

(ii) The term qualified REIT dividend does not include any REIT dividend received with respect to any share of REIT stock—

(A) That is held by the shareholder for 45 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which such share becomes ex-dividend with respect to such dividend; or

(B) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(3) *Qualified PTP income*—(i) *In general.* The term *qualified PTP income* means the sum of—

(A) The net amount of such taxpayer's allocable share of income, gain, deduction, and loss from a PTP as defined in section 7704(b) that is not taxed as a corporation under section 7704(a); plus

(B) Any gain or loss attributable to assets of the PTP giving rise to ordinary income under section 751(a) or (b) that is considered attributable to the trades or businesses conducted by the partnership.

(ii) *Special rules.* The rules applicable to the determination of QBI described in paragraph (b) of this section also apply to the determination of a taxpayer's allocable share of income, gain, deduction, and loss from a PTP. An individual's allocable share of income from a PTP, and any section 751 gain or loss is qualified PTP income only to the extent the items meet the qualifications of section 199A and this section, including the requirement that the item is included or allowed in determining taxable income for the taxable year, and the requirement that the item be effectively connected with the conduct of a trade or business within the United States. For example, if an individual owns an interest in a PTP, and for the taxable year is allocated a distributive share of net loss which is disallowed under the passive activity rules of section 469, such loss is not taken into account for purposes of section 199A. The specified service trade or business limitations described in §§ 1.199A–1(d)(3) and 1.199A–5 also apply to income earned from a PTP. Furthermore, each PTP is required to determine its qualified PTP income for each trade or business and report that information to its owners as described in § 1.199A–6(b)(3).

(d) *Section 199A dividends paid by a regulated investment company*—(1) *In general*. If section 852(b) applies to a regulated investment company (RIC) for a taxable year, the RIC may pay section 199A dividends, as defined in this paragraph (d).

(2) *Definition of section 199A dividend*—(i) *In general*. Except as provided in paragraph (d)(2)(ii) of this section, a section 199A dividend is any dividend or part of such a dividend that a RIC pays to its shareholders and reports as a section 199A dividend in written statements furnished to its shareholders.

(ii) *Reduction in the case of excess reported amounts*. If the aggregate reported amount with respect to the RIC for any taxable year exceeds the RIC's qualified REIT dividend income for the taxable year, then a section 199A dividend is equal to—

(A) The reported section 199A dividend amount; reduced by

(B) The excess reported amount that is allocable to that reported section 199A dividend amount.

(iii) *Allocation of excess reported amount*—(A) *In general*. Except as provided in paragraph (d)(2)(iii)(B) of this section, the excess reported amount (if any) that is allocable to the reported section 199A dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 199A dividend amount bears to the aggregate reported amount.

(B) *Special rule for noncalendar-year RICs*. In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (d)(2)(iii)(A) of this section is applied by substituting ''post-December reported amount'' for ''aggregate reported amount,'' and no excess reported amount is allocated to any dividend paid on or before December 31 of that taxable year.

(3) *Definitions*. For purposes of paragraph (d) of this section—

(i) *Reported section 199A dividend amount*. The term *reported section 199A dividend amount* means the amount of a dividend distribution reported to the RIC's shareholders under paragraph (d)(2)(i) of this section as a section 199A dividend.

(ii) *Excess reported amount*. The term *excess reported amount* means the excess of the aggregate reported amount over the RIC's qualified REIT dividend income for the taxable year.

(iii) *Aggregate reported amount*. The term *aggregate reported amount* means the aggregate amount of dividends reported by the RIC under paragraph (d)(2)(i) of this section as section 199A dividends for the taxable year (including section 199A dividends paid after the close of the taxable year and described in section 855).

(iv) *Post-December reported amount*. The term *post-December reported amount* means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(v) *Qualified REIT dividend income*. The term *qualified REIT dividend income* means, with respect to a taxable year of a RIC, the excess of the amount of qualified REIT dividends, as defined in paragraph (c)(2) of this section, includible in the RIC's taxable income for the taxable year over the amount of the RIC's deductions that are properly allocable to such income.

(4) *Treatment of section 199A dividends by shareholders*—(i) *In general*. For purposes of section 199A, and §§ 1.199A–1 through 1.199A–6, a section 199A dividend is treated by a taxpayer that receives the section 199A dividend as a qualified REIT dividend.

(ii) *Holding period*. Paragraph (d)(4)(i) of this section does not apply to any dividend received with respect to a share of RIC stock—

(A) That is held by the shareholder for 45 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 91-day period beginning on the date which is 45 days before the date on which the share becomes ex-dividend with respect to such dividend; or

(B) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(5) *Example.* The following example illustrates the provisions of this paragraph (d).

(i) X is a corporation that has elected to be a RIC. For its taxable year ending March 31, 2021, X has $25,000x of net long-term capital gain, $60,000x of qualified dividend income, $25,000x of taxable interest income, $15,000x of net short-term capital gain, and $25,000x of qualified REIT dividends. X has $15,000x of deductible expenses, of which $3,000x is allocable to the qualified REIT dividends. On December 31, 2020, X pays a single dividend of $100,000x, and reports $20,000x of the dividend as a section 199A dividend in written statements to its shareholders. On March 31, 2021, X pays a dividend of $35,000x, and reports $5,000x of the dividend as a section 199A dividend in written statements to its shareholders.

(ii) X's qualified REIT dividend income under paragraph (d)(3)(v) of this section is $22,000x, which is the excess of X's $25,000x of qualified REIT dividends over $3,000x in allocable expenses. The reported section 199A dividend amounts for the December 31, 2020, and March 31, 2021, distributions are $20,000x and $5,000x, respectively. For the taxable year ending March 31, 2021, the aggregate reported amount of section 199A dividends is $25,000x, and the excess reported amount under paragraph (d)(3)(ii) of this section is $3,000x. Because X is a noncalendar-year RIC and the post-December reported amount of $5,000x exceeds the excess reported amount of $3,000x, the entire excess reported amount is allocated under paragraphs (d)(2)(iii)(A) and (B) of this section to the reported section 199A dividend amount for the March 31, 2021, distribution. No portion of the excess reported amount is allocated to the reported section 199A dividend amount for the December 31, 2020, distribution. Thus, the section 199A dividend on March 31, 2021, is $2,000x, which is the reported section 199A dividend amount of $5,000x reduced by the $3,000x of allocable excess reported amount. The section 199A dividend on December 31, 2020, is the $20,000x that X reports as a section 199A dividend.

(iii) Shareholder A, a United States person, receives a dividend from X of $100x on December 31, 2020, of which $20x is reported as a section 199A dividend. If A meets the holding period requirements in paragraph (d)(4)(ii) of this section with respect to the stock of X, A treats $20x of the dividend from X as a qualified REIT dividend for purposes of section 199A for A's 2020 taxable year.

(iv) A receives a dividend from X of $35x on March 31, 2021, of which $5x is reported as a section 199A dividend. Only $2x of the dividend is a section 199A dividend. If A meets the holding period requirements in paragraph (d)(4)(ii) of this section with respect to the stock of X, A may treat the $2x section 199A dividend as a qualified REIT dividend for A's 2021 taxable year.

(e) *Applicability date*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exceptions*—(i) *Anti-abuse rules.* The provisions of paragraph (c)(2)(ii) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE.* For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

(iii) *Previously disallowed losses.* The provisions of paragraph (b)(1)(iv) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (b)(1)(iv) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (b)(1)(iv) of this section for each such year.

(iv) *Section 199A dividends.* The provisions of paragraph (d) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (d) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (d) of this section for each such year.

[T.D. 9847, 84 FR 3000, Feb. 8, 2019, as amended by T.D. 9899, 85 FR 38065, June 25, 2020]

§ 1.199A–4 Aggregation.

(a) *Scope and purpose.* An individual or RPE may be engaged in more than one trade or business. Except as provided in this section, each trade or business is a separate trade or business for purposes of applying the limitations described in §1.199A–1(d)(2)(iv). This section sets forth rules to allow individuals and RPEs to aggregate trades or businesses, treating the aggregate as a single trade or business for purposes of applying the limitations described in §1.199A–1(d)(2)(iv). Trades or businesses may be aggregated only to the extent provided in this section, but aggregation by taxpayers is not required.

(b) *Aggregation rules*—(1) *General rule.* Trades or businesses may be aggregated only if an individual or RPE can demonstrate that—

(i) The same person or group of persons, directly or by attribution under sections 267(b) or 707(b), owns 50 percent or more of each trade or business to be aggregated, meaning in the case of such trades or businesses owned by an S corporation, 50 percent or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50 percent or more of the capital or profits in the partnership;

(ii) The ownership described in paragraph (b)(1)(i) of this section exists for a majority of the taxable year, including the last day of the taxable year, in which the items attributable to each trade or business to be aggregated are included in income;

(iii) All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years;

(iv) None of the trades or businesses to be aggregated is a *specified service trade or business* (SSTB) as defined in §1.199A–5; and

(v) The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):

(A) The trades or businesses provide products, property, or services that are the same or customarily offered together.

(B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

(C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

(2) *Operating rules*—(i) *Individuals.* An individual may aggregate trades or businesses operated directly or through an RPE to the extent an aggregation is not inconsistent with the aggregation of an RPE. If an individual aggregates multiple trades or businesses under paragraph (b)(1) of this section, QBI, W–2 wages, and UBIA of qualified property must be combined for the aggregated trades or businesses for purposes of applying the W–2 wage and UBIA of qualified property limitations described in §1.199A–1(d)(2)(iv). An individual may not subtract from the trades or businesses aggregated by an RPE but may aggregate additional trades or businesses with the RPE's aggregation if the rules of this section are otherwise satisfied.

(ii) *RPEs.* An RPE may aggregate trades or businesses operated directly or through a lower-tier RPE to the extent an aggregation is not inconsistent with the aggregation of a lower-tier RPE. If an RPE itself does not aggregate, multiple owners of an RPE need not aggregate in the same manner. If an RPE aggregates multiple trades or businesses under paragraph (b)(1) of this section, the RPE must compute and report QBI, W–2 wages, and UBIA of qualified property for the aggregated trade or business under the rules described in §1.199A–6(b). An RPE may not subtract from the trades or businesses aggregated by a lower-tier RPE but may aggregate additional trades or businesses with a lower-tier RPE's aggregation if the rules of this section are otherwise satisfied.

(c) *Reporting and consistency requirements*—(1) *Individuals.* Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An individual that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an individual may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (including the aggregated trade or business of an RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an individual's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the individual must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest.

(2) *Individual disclosure*—(i) *Required annual disclosure.* For each taxable year, individuals must attach a statement to their returns identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain—

(A) A description of each trade or business;

(B) The name and EIN of each entity in which a trade or business is operated;

(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;

(D) Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest; and

(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) *Failure to disclose.* If an individual fails to attach the statement required in paragraph (c)(2)(i) of this section, the Commissioner may disaggregate the individual's trades or businesses. The individual may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

(3) *RPEs.* Once an RPE chooses to aggregate two or more trades or businesses, the RPE must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An RPE that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an RPE may add a newly created or newly acquired (including through non-recognition transfers) trade or business to an existing aggregated trade or business (including the aggregated trade or business of a lower-tier RPE) if the requirements of paragraph (b)(1) of this section are satisfied. In a subsequent year, if there is a significant change in facts and circumstances such that an RPE's prior aggregation of trades or businesses no longer qualifies for aggregation under the rules of this section, then the trades or businesses will no longer be aggregated within the meaning of this section, and the RPE must reapply the rules in paragraph (b)(1) of this section to determine a new permissible aggregation (if any). An RPE also must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest.

(4) *RPE disclosure*—(i) *Required annual disclosure.* For each taxable year, RPEs (including each RPE in a tiered structure) must attach a statement to each owner's Schedule K–1 identifying each trade or business aggregated under paragraph (b)(1) of this section. The statement must contain—

(A) A description of each trade or business;

(B) The name and EIN of each entity in which a trade or business is operated;

(C) Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;

(D) Information identifying any aggregated trade or business of an RPE in which the RPE holds an ownership interest; and

(E) Such other information as the Commissioner may require in forms, instructions, or other published guidance.

(ii) *Failure to disclose.* If an RPE fails to attach the statement required in paragraph (c)(4)(i) of this section, the Commissioner may disaggregate the RPE's trades or businesses. The RPE may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years.

(d) *Examples.* The following examples illustrate the principles of this section. For purposes of these examples, assume the taxpayer is a United States citizen, all individuals and RPEs use a calendar taxable year, there are no ownership changes during the taxable year, all trades or businesses satisfy the requirements under section 162, all tax items are effectively connected to a trade or business within the United States within the meaning of section 864(c), and none of the trades or businesses is an SSTB within the meaning of §1.199A–5. Except as otherwise specified, a single capital letter denotes an individual taxpayer.

(1) *Example 1*—(i) *Facts.* A wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. A maintains a website and print advertising materials that reference both the catering business and the restaurant. A uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

(ii) *Analysis.* Because the restaurant and catering business are held in disregarded entities, A will be treated as operating each of these businesses directly and thereby satisfies paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, A satisfies the following factors: Paragraph (b)(1)(v)(A) of this section is met as both businesses offer prepared food to customers; and paragraph (b)(1)(v)(B) of this section is met because the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting. Having satisfied paragraphs (b)(1)(i) through (v) of this section, A may treat the catering business and the restaurant as a single trade or business for purposes of applying §1.199A–1(d).

(2) *Example 2*—(i) *Facts.* Assume the same facts as in *Example 1* of paragraph (d)(1) of this section, but the catering and restaurant businesses are owned in separate partnerships and A, B, C, and D each own a 25% interest in each of the two partnerships. A, B, C, and D are unrelated.

(ii) *Analysis.* Because under paragraph (b)(1)(i) of this section A, B, C, and D together own more than 50% of each of the two partnerships, they may each treat the catering business and the restaurant as a single trade or business for purposes of applying §1.199A–1(d).

(3) *Example 3*—(i) *Facts.* W owns a 75% interest in S1, an S corporation, and a 75% interest in PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. W manages S1 and PRS.

(ii) *Analysis.* W owns more than 50% of the stock of S1 and more than 50% of PRS thereby satisfying paragraph (b)(1)(i) of this section. Although W manages both S1 and PRS, W is not able to satisfy the requirements of paragraph (b)(1)(v) of this section as the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. W must treat S1 and PRS as separate trades or businesses for purposes of applying §1.199A–1(d).

(4) *Example 4*—(i) *Facts*. E owns a 60% interest in each of four partnerships (PRS1, PRS2, PRS3, and PRS4). Each partnership operates a hardware store. A team of executives oversees the operations of all four of the businesses and controls the policy decisions involving the business as a whole. Human resources and accounting are centralized for the four businesses. E reports PRS1, PRS3, and PRS4 as an aggregated trade or business under paragraph (b)(1) of this section and reports PRS2 as a separate trade or business. Only PRS2 generates a net taxable loss.

(ii) *Analysis*. E owns more than 50% of each partnership thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the following factors are satisfied: Paragraph (b)(1)(v)(A) of this section because each partnership operates a hardware store; and paragraph (b)(1)(v)(B) of this section because the businesses share accounting and human resource functions. E's decision to aggregate only PRS1, PRS3, and PRS4 into a single trade or business for purposes of applying § 1.199A–1(d) is permissible. The loss from PRS2 will be netted against the aggregate profits of PRS1, PRS3, and PRS4 pursuant to § 1.199A–1(d)(2)(iii).

(5) *Example 5*—(i) *Facts*. Assume the same facts as *Example 4* of paragraph (d)(4) of this section, and that F owns a 10% interest in PRS1, PRS2, PRS3, and PRS4.

(ii) *Analysis*. Because under paragraph (b)(1)(i) of this section E owns more than 50% of the four partnerships, F may aggregate PRS 1, PRS2, PRS3, and PRS4 as a single trade or business for purposes of applying § 1.199A–1(d), provided that F can demonstrate that the ownership test is met by E.

(6) *Example 6*—(i) *Facts*. D owns 75% of the stock of S1, S2, and S3, each of which is an S corporation. Each S corporation operates a grocery store in a separate state. S1 and S2 share centralized purchasing functions to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. S3 is operated independently from the other businesses.

(ii) *Analysis*. D owns more than 50% of the stock of each S corporation thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the grocery stores satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business. Only S1 and S2 satisfy paragraph (b)(1)(v)(B) of this section because of their centralized purchasing and accounting offices. D is only able to show that the requirements of paragraph (b)(1)(v)(B) of this section are satisfied for S1 and S2; therefore, D only may aggregate S1 and S2 into a single trade or business for purposes of § 1.199A–1(d). D must report S3 as a separate trade or business for purposes of applying § 1.199A–1(d).

(7) *Example 7*—(i) *Facts*. Assume the same facts as *Example 6* of paragraph (d)(6) of this section except each store is independently operated and S1 and S2 do not have centralized purchasing or accounting functions.

(ii) *Analysis*. Although the stores provide the same products and services within the meaning of paragraph (b)(1)(v)(A) of this section, D cannot show that another factor under paragraph (b)(1)(v) of this section is present. Therefore, D must report S1, S2, and S3 as separate trades or businesses for purposes of applying § 1.199A–1(d).

(8) *Example 8*—(i) *Facts*. G owns 80% of the stock in S1, an S corporation and 80% of LLC1 and LLC2, each of which is a partnership for Federal tax purposes. LLC1 manufactures and supplies all of the widgets sold by LLC2. LLC2 operates a retail store that sells LLC1's widgets. S1 owns the real property leased to LLC1 and LLC2 for use by the factory and retail store. The entities share common advertising and management.

(ii) *Analysis*. G owns more than 50% of the stock of S1 and more than 50% of LLC1 and LLC2 thus satisfying paragraph (b)(1)(i) of this section. LLC1, LLC2, and S1 share significant centralized business elements and are operated in coordination with, or in reliance upon, one or more of the businesses in the aggregated group. G can treat the business operations of LLC1 and LLC2 as a single trade or business for purposes of applying §1.199A–1(d). S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in §1.199A–1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

(9) *Example 9*—(i) *Facts.* Same facts as *Example 8* of paragraph (d)(8) of this section, except G owns 80% of the stock in S1 and 20% of each of LLC1 and LLC2. B, G's son, owns a majority interest in LLC2, and M, G's mother, owns a majority interest in LLC1. B does not own an interest in S1 or LLC1, and M does not own an interest in S1 or LLC2.

(ii) *Analysis.* Under the rules in paragraph (b)(1) of this section, B and M's interest in LLC2 and LLC1, respectively, are attributable to G and G is treated as owning a majority interest in LLC2 and LLC1; G thus satisfies paragraph (b)(1)(i) of this section. G may aggregate his interests in LLC1, LLC2, and S1 as a single trade or business for purposes of applying §1.199A–1(d). Under paragraph (b)(1) of this section, S1 is eligible to be included in the aggregated group because it leases property to a trade or business within the aggregated trade or business as described in §1.199A–1(b)(14) and meets the requirements of paragraph (b)(1) of this section.

(10) *Example 10*—(i) *Facts.* F owns a 75% interest and G owns a 5% interest in five partnerships (PRS1–PRS5). H owns a 10% interest in PRS1 and PRS2. Each partnership operates a restaurant and each restaurant separately constitutes a trade or business for purposes of section 162. G is the executive chef of all of the restaurants and as such he creates the menus and orders the food supplies.

(ii) *Analysis.* F owns more than 50% of the partnerships thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, the restaurants satisfy paragraph (b)(1)(v)(A) of this section because they are in the same trade or business, and paragraph (b)(1)(v)(B) of this section is satisfied as G is the executive chef of all of the restaurants and the businesses share a centralized function for ordering food and supplies. F can show the requirements under paragraph (b)(1) of this section are satisfied as to all of the restaurants. Because F owns a majority interest in each of the partnerships, G can demonstrate that paragraph (b)(1)(i) of this section is satisfied. G can also aggregate all five restaurants into a single trade or business for purposes of applying §1.199A–1(d). H, however, only owns an interest in PRS1 and PRS2. Like G, H satisfies paragraph (b)(1)(i) of this section because F owns a majority interest. H can, therefore, aggregate PRS1 and PRS2 into a single trade or business for purposes of applying §1.199A–1(d).

(11) *Example 11*—(i) *Facts.* H, J, K, and L own interests in PRS1 and PRS2, each a partnership, and S1 and S2, each an S corporation. H, J, K, and L also own interests in C, an entity taxable as a C corporation. H owns 30%, J owns 20%, K owns 5%, and L owns 45% of each of the five entities. All of the entities satisfy 2 of the 3 factors under paragraph (b)(1)(v) of this section. For purposes of section 199A the taxpayers report the following aggregated trades or businesses: H aggregates PRS1 and S1 together and aggregates PRS2 and S2 together; J aggregates PRS1, S1 and S2 together and reports PRS2 separately; K aggregates PRS1 and PRS2 together and aggregates S1 and S2 together; and L aggregates S1, S2, and PRS2 together and reports PRS1 separately. C cannot be aggregated.

(ii) *Analysis.* Under paragraph (b)(1)(i) of this section, because H, J, and K together own a majority interest in PRS1, PRS2, S1, and S2, H, J, K, and L are permitted to aggregate under paragraph (b)(1) of this section. Further, the aggregations reported by the taxpayers are permitted, but not required for each of H, J, K, and L. C's income is not eligible for the section 199A deduction and it cannot be aggregated for purposes of applying §1.199A–1(d).

(12) *Example 12*—(i) *Facts.* L owns 60% of PRS1, a partnership, a business that sells non-food items to grocery stores. L also owns 55% of PRS2, a partnership, which owns and operates a distribution trucking business. The predominant portion of PRS2's business is transporting goods for PRS1.

(ii) *Analysis.* L is able to meet paragraph (b)(1)(i) of this section as the majority owner of PRS1 and PRS2. Under paragraph (b)(1)(v) of this section, L is only able to show the operations of PRS1 and PRS2 are operated in reliance of one another under paragraph (b)(1)(v)(C) of this section. For purposes of applying §1.199A–1(d), L must treat PRS1 and PRS2 as separate trades or businesses.

(13) *Example 13*—(i) *Facts.* C owns a majority interest in a sailboat racing team and also owns an interest in PRS1 which operates a marina. PRS1 is a trade or business under section 162, but the sailboat racing team is not a trade or business within the meaning of section 162.

(ii) *Analysis.* C has only one trade or business for purposes of section 199A and, therefore, cannot aggregate the interest in the racing team with PRS1 under paragraph (b)(1) of this section.

(14) *Example 14*—(i) *Facts.* Trust wholly owns LLC1, LLC2, and LLC3. LLC1 operates a trucking company that delivers lumber and other supplies sold by LLC2. LLC2 operates a lumber yard and supplies LLC3 with building materials. LLC3 operates a construction business. LLC1, LLC2, and LLC3 have a centralized human resources department, payroll, and accounting department.

(ii) *Analysis.* Because Trust owns 100% of the interests in LLC1, LLC2, and LLC3, Trust satisfies paragraph (b)(1)(i) of this section. Trust can also show that it satisfies paragraph (b)(1)(v)(B) of this section as the trades or businesses have a centralized human resources department, payroll, and accounting department. Trust also can show is meets paragraph (b)(1)(v)(C) of this section as the trades or businesses are operated in coordination, or reliance upon, one or more in the aggregated group. Trust can aggregate LLC1, LLC2, and LLC3 for purposes of applying §1.199A–1(d).

(15) *Example 15*—(i) *Facts.* PRS1, a partnership, directly operates a food service trade or business and owns 60% of PRS2, which directly operates a movie theater trade or business and a food service trade or business. PRS2's movie theater and food service businesses operate in coordination with, or reliance upon, one another and share a centralized human resources department, payroll, and accounting department. PRS1's and PRS2's food service businesses provide products and services that are the same and share centralized purchasing and shipping to obtain volume discounts.

(ii) *Analysis.* PRS2 may aggregate its movie theater and food service businesses. Paragraph (b)(1)(v) of this section is satisfied because the businesses operate in coordination with one another and share centralized business elements. If PRS2 does aggregate the two businesses, PRS1 may not aggregate its food service business with PRS2's aggregated trades or businesses. Because PRS1 owns more than 50% of PRS2, thereby satisfying paragraph (b)(1)(i) of this section, PRS1 may aggregate its food service businesses with PRS2's food service business if PRS2 has not aggregated its movie theater and food service businesses. Paragraph (b)(1)(v) of this section is satisfied because the businesses provide the same products and services and share centralized business elements. Under either alternative, PRS1's food service business and PRS2's movie theater cannot be aggregated because there are no factors in paragraph (b)(1)(v) of this section present between the businesses.

(16) *Example 16*—(i) *Facts.* PRS1, a partnership, owns 60% of a commercial rental office building in state A, and 80% of a commercial rental office building in state B. Both commercial rental office building operations share centralized accounting, legal, and human resource functions. PRS1 treats the two commercial rental office buildings as an aggregated trade or business under paragraph (b)(1) of this section.

(ii) *Analysis.* PRS1 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Under paragraph (b)(1)(v) of this section, PRS1 may aggregate its commercial rental office buildings because the businesses provide the same type of property and share accounting, legal, and human resource functions.

(17) *Example 17*—(i) *Facts.* S, an S corporation owns 100% of the interests in a residential condominium building

and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

(ii) *Analysis.* S owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Although both businesses share significant centralized business elements, S cannot show that another factor under paragraph (b)(1)(v) of this section is present because the two building operations are not of the same type of property. S must treat the residential condominium building and the commercial rental office building as separate trades or businesses for purposes of applying § 1.199A–1(d).

(18) *Example 18*—(i) *Facts.* M owns 75% of a residential apartment building. M also owns 80% of PRS2. PRS2 owns 80% of the interests in a residential condominium building and 80% of the interests in a residential apartment building. PRS2's residential condominium building and residential apartment building operations share centralized back office functions and management. M's residential apartment building and PRS2's residential condominium and apartment building operate in coordination with each other in renting apartments to tenants.

(ii) *Analysis.* PRS2 may aggregate its residential condominium and residential apartment building operations. PRS2 owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is satisfied because the businesses are of the same type of property and share centralized back office functions and management. M may also add its residential apartment building operations to PRS2's aggregated residential condominium and apartment building operations. M owns more than 50% of each trade or business thereby satisfying paragraph (b)(1)(i) of this section. Paragraph (b)(1)(v) of this section is also satisfied because the businesses operate in coordination with each other.

(e) *Applicability date*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exception for non-calendar year RPE.* For purposes of determining QBI, W–2 wages, and UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

[T.D. 9847, 84 FR 3002, Feb. 8, 2019, as amended by T.D. 9847, 84 FR 15955, Apr. 17, 2019]

§ 1.199A–5 Specified service trades or businesses and the trade or business of performing services as an employee.

(a) *Scope and effect*—(1) *Scope.* This section provides guidance on specified service trades or businesses (SSTBs) and the trade or business of performing services as an employee. This paragraph (a) describes the effect of a trade or business being an SSTB and the trade or business of performing services as an employee. Paragraph (b) of this section provides definitional guidance on SSTBs. Paragraph (c) of this section provides special rules related to SSTBs. Paragraph (d) of this section provides guidance on the trade or business of performing services as an employee. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) *Effect of being an SSTB.* If a trade or business is an SSTB, no qualified business income (QBI), W–2 wages, or unadjusted basis immediately after acquisition (UBIA) of qualified property from the SSTB may be taken into account by any individual whose taxable income exceeds the phase-in range as defined in §1.199A–1(b)(4), even if the item is derived from an activity that is not itself a specified service activity. The SSTB limitation also applies to income earned from a publicly traded partnership (PTP). If a trade or business conducted by a relevant passthrough entity (RPE) or PTP is an SSTB, this limitation applies to any

direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity. However, the SSTB limitation does not apply to individuals with taxable income below the threshold amount as defined in §1.199A–1(b)(12). A phase-in rule, provided in §1.199A–1(d)(2), applies to individuals with taxable income within the phase-in range, allowing them to take into account a certain ''applicable percentage'' of QBI, W–2 wages, and UBIA of qualified property from an SSTB. The phase-in rule also applies to income earned from a PTP. A direct or indirect owner of a trade or business engaged in the performance of a specified service is engaged in the performance of the specified service for purposes of section 199A and this section, regardless of whether the owner is passive or participated in the specified service activity.

(3) *Trade or business of performing services as an employee.* The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, deduction, or loss from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and §1.199A–3. No taxpayer may claim a section 199A deduction for wage income, regardless of the amount of taxable income.

(b) *Definition of specified service trade or business.* Except as provided in paragraph (c)(1) of this section, the term *specified service trade or business (SSTB)* means any of the following:

(1) *Listed SSTBs.* Any trade or business involving the performance of services in one or more of the following fields:

(i) *Health* as described in paragraph (b)(2)(ii) of this section;

(ii) *Law* as described in paragraph (b)(2)(iii) of this section;

(iii) *Accounting* as described in paragraph (b)(2)(iv) of this section;

(iv) *Actuarial science* as described in paragraph (b)(2)(v) of this section;

(v) *Performing arts* as described in paragraph (b)(2)(vi) of this section;

(vi) *Consulting* as described in paragraph (b)(2)(vii) of this section;

(vii) *Athletics* as described in paragraph (b)(2)(viii) of this section;

(viii) *Financial services* as described in paragraph (b)(2)(ix) of this section;

(ix) *Brokerage services* as described in paragraph (b)(2)(x) of this section;

(x) *Investing and investment management* as described in paragraph (b)(2)(xi) of this section;

(xi) *Trading* as described in paragraph (b)(2)(xii) of this section;

(xii) *Dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2))* as described in paragraph (b)(2)(xiii) of this section; or

(xiii) *Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners* as defined in paragraph (b)(2)(xiv) of this section.

(2) *Additional rules for applying section 199A(d)(2) and paragraph (b) of this section*—(i) *In general*—(A) *No effect on other tax rules.* This paragraph (b)(2) provides additional rules for determining whether a business is an SSTB within the meaning of section 199A(d)(2) and paragraph (b) of this section only. The rules of this paragraph (b)(2) apply solely for purposes of section 199A and therefore may not be taken into account for purposes of applying any provision of law or regulation other than section 199A and the regulations thereunder, except to the extent such provision expressly refers to section 199A(d) or this section.

(B) *Hedging transactions.* Income, deduction, gain or loss from a *hedging transaction* (as defined in §1.1221–2(b)) entered into by an individual or RPE in the normal course of the individual's or RPE's trade or business is treated as income, deduction, gain, or loss from that trade or business for purposes of this paragraph (b)(2). See also §1.446–4.

(ii) *Meaning of services performed in the field of health.* For purposes of section 199A(d)(2) and paragraph (b)(1)(i) of this section only, the *performance of services in the field of health* means the provision of medical services by individuals such as physicians, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other similar healthcare professionals performing services in their capacity as such. The performance of services in the field of health does not include the provision of services not directly related to a medical services field, even though the services provided may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers, payment processing, or the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.

(iii) *Meaning of services performed in the field of law.* For purposes of section 199A(d)(2) and paragraph (b)(1)(ii) of this section only, the *performance of services in the field of law* means the performance of legal services by individuals such as lawyers, paralegals, legal arbitrators, mediators, and similar professionals performing services in their capacity as such. The performance of services in the field of law does not include the provision of services that do not require skills unique to the field of law; for example, the provision of services in the field of law does not include the provision of services by printers, delivery services, or stenography services.

(iv) *Meaning of services performed in the field of accounting.* For purposes of section 199A(d)(2) and paragraph (b)(1)(iii) of this section only, the *performance of services in the field of accounting* means the provision of services by individuals such as accountants, enrolled agents, return preparers, financial auditors, and similar professionals performing services in their capacity as such.

(v) *Meaning of services performed in the field of actuarial science.* For purposes of section 199A(d)(2) and paragraph (b)(1)(iv) of this section only, the *performance of services in the field of actuarial science* means the provision of services by individuals such as actuaries and similar professionals performing services in their capacity as such.

(vi) *Meaning of services performed in the field of performing arts.* For purposes of section 199A(d)(2) and paragraph (b)(1)(v) of this section only, the *performance of services in the field of the performing arts* means the performance of services by individuals who participate in the creation of performing arts, such as actors, singers, musicians, entertainers, directors, and similar professionals performing services in their capacity as such. The performance of services in the field of performing arts does not include the provision of services that do not require skills unique to the creation of performing arts, such as the maintenance and operation of equipment or facilities for use in the performing arts. Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of performing arts to the public.

(vii) *Meaning of services performed in the field of consulting.* For purposes of section 199A(d)(2) and paragraph (b)(1)(vi) of this section only, the *performance of services in the field of consulting* means the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems. Consulting includes providing advice and counsel regarding advocacy with the intention of influencing decisions made by a government or governmental agency and all attempts to influence legislators and other government officials on behalf of a client by lobbyists and other similar professionals performing services in their capacity as such. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales (or economically similar services) or the provision of training and educational courses. For purposes of the preceding sentence, the determination of whether a person's services are sales or economically similar services will be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided. Performance of services in the field of consulting does not include the performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise not an SSTB (such as typical services provided by a building contractor) if there is no separate payment for the consulting services. Services within the fields of architecture and engineering are not treated as consulting services.

(viii) *Meaning of services performed in the field of athletics.* For purposes of section 199A(d)(2) and paragraph (b)(1)(vii) of this section only, the *performance of services in the field of athletics* means the performance of services by individuals who participate in athletic competition such as athletes, coaches, and team managers in sports such as baseball, basketball, football, soccer, hockey, martial arts, boxing, bowling, tennis, golf, skiing, snowboarding, track and field, billiards, and racing. The performance of services in the field of athletics does not include the provision of services that do not require skills unique to athletic competition, such as the maintenance and operation of equipment or facilities for use in athletic events. Similarly, the performance of services in the field of athletics does not include the provision of services by persons who broadcast or otherwise disseminate video or audio of athletic events to the public.

(ix) *Meaning of services performed in the field of financial services.* For purposes of section 199A(d)(2) and paragraph (b)(1)(viii) of this section only, the *performance of services in the field of financial services* means the provision of financial services to clients including managing wealth, advising clients with respect to finances, developing retirement plans, developing wealth transition plans, the provision of advisory and other similar services regarding valuations, mergers, acquisitions, dispositions, restructurings (including in title 11 of the Code or similar cases), and raising financial capital by underwriting, or acting as a client's agent in the issuance of securities and similar services. This includes services provided by financial advisors, investment bankers, wealth planners, retirement advisors, and other similar professionals performing services in their capacity as such. Solely for purposes of section 199A, the performance of services in the field of financial services does not include taking deposits or making loans, but does include arranging lending transactions between a lender and borrower.

(x) *Meaning of services performed in the field of brokerage services.* For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the *performance of services in the field of brokerage services* includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers.

(xi) *Meaning of the provision of services in investing and investment management.* For purposes of section 199A(d)(2) and paragraph (b)(1)(x) of this section only, the *performance of services that consist of investing and investment management* refers to a trade or business involving the receipt of fees for providing investing, asset management, or investment management services, including providing advice with respect to buying and selling investments. The performance of services of investing and investment management does not include directly managing real property.

(xii) *Meaning of the provision of services in trading.* For purposes of section 199A(d)(2) and paragraph (b)(1)(xi) of this section only, the *performance of services that consist of trading* means a trade or business of trading in securities (as defined in section 475(c)(2)), commodities (as defined in section 475(e)(2)), or partnership interests. Whether a person is a trader in securities, commodities, or partnership interests is determined by taking into account all relevant facts and circumstances, including the source and type of profit that is associated with engaging in the activity regardless of whether that person trades for the person's own account, for the account of others, or any combination thereof.

(xiii) *Meaning of the provision of services in dealing*—(A) *Dealing in securities.* For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, *the performance of services that consist of dealing in securities (as defined* *in section 475(c)(2))* means regularly purchasing securities from and selling securities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, the performance of services to originate a loan is not treated as the purchase of a security from the borrower in determining whether the lender is dealing in securities.

(B) *Dealing in commodities.* For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, *the performance of services that consist of dealing in commodities (as defined in section 475(e)(2))* means regularly purchasing commodities from and selling commodities to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in commodities with customers in the ordinary course of a trade or business. Solely for purposes of the preceding sentence, gains and losses from qualified active sales as defined in paragraph (b)(2)(xiii)(B)(*1*) of this section are not taken into account in determining whether a person is engaged in the trade or business of dealing in commodities.

(*1*) *Qualified active sale.* The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities if the trade or business is as an active producer, processor, merchant or handler of commodities. A hedging transaction described in paragraph (b)(2)(i)(B) of this section is treated as a qualified active sale. The sale of commodities held by a trade or business other than in its capacity as an active producer, processor, merchant, or handler of commodities is not a qualified active sale. For example, the sale by a trade or business of commodities that were held for investment or speculation would not be a qualified active sale.

(*2*) *Active conduct of a commodities business.* For purposes of paragraph (b)(2)(xiii)(B)(*1*) of this section, a trade or business is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only with respect to commodities for which each of the conditions described in paragraphs (b)(2)(xiii)(B)(*3*) through (*5*) of this section are satisfied.

(*3*) *Directly holds commodities as inventory or similar property.* The commodities trade or business holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property. The term inventory or similar property means property that is stock in trade of the trade or business or other property of a kind that would properly be included in the inventory of the trade or business if on hand at the close of the taxable year, or property held by the trade or business primarily for sale to customers in the ordinary course of its trade or business.

(*4*) *Directly incurs substantial expenses in the ordinary course.* The commodities trade or business incurs substantial expenses in the ordinary course of the commodities trade or business from engaging in one or more of the following activities directly, and not through an agent or independent contractor—

(*i*) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(*ii*) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(*iii*) Significant activities as described in paragraph (b)(2)(xiii)(B)(*5*) of this section.

(*5*) *Significant activities for purposes of paragraph (b)(2)(xiii)(B)(4)(iii) of this section.* The commodities trade or business performs significant activities with respect to the commodities that consists of—

(*i*) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging transportation, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(*ii*) Owning and operating facilities for storage or warehousing; or

(*iii*) Owning, chartering, or leasing vessels or vehicles for the transportation of the commodities.

(C) *Dealing in partnership interests.* For purposes of section 199A(d)(2) and paragraph (b)(1)(xii) of this section only, *the performance of services that consist of dealing in partnership interests* means regularly purchasing partnership interests from and selling partnership interests to customers in the ordinary course of a trade or business or regularly offering to enter into, assume, offset, assign, or otherwise terminate positions in partnership interests with customers in the ordinary course of a trade or business.

(xiv) *Meaning of trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners.* For purposes of section 199A(d)(2) and paragraph (b)(1)(xiii) of this section only, the term *any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners* means any trade or business that consists of any of the following (or any combination thereof):

(A) A trade or business in which a person receives fees, compensation, or other income for endorsing products or services;

(B) A trade or business in which a person licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity; or

(C) Receiving fees, compensation, or other income for appearing at an event or on radio, television, or another media format.

(D) For purposes of paragraphs (b)(2)(xiv)(A) through (C) of this section, the term *fees, compensation, or other income* includes the receipt of a partnership interest and the corresponding distributive share of income, deduction, gain, or loss from the partnership, or the receipt of stock of an S corporation and the corresponding income, deduction, gain, or loss from the S corporation stock.

(3) *Examples.* The following examples illustrate the rules in paragraphs (a) and (b) of this section. The examples do not address all types of services that may or may not qualify as specified services. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

(i) *Example 1.* B is a board-certified pharmacist who contracts as an independent contractor with X, a small medical facility in a rural area. X employs one full time pharmacist, but contracts with B when X's needs exceed the capacity of its full-time staff. When engaged by X, B is responsible for receiving and reviewing orders from physicians providing medical care at the facility; making recommendations on dosing and alternatives to the ordering physician; performing inoculations, checking for drug interactions, and filling pharmaceutical orders for patients receiving care at X. B is engaged in the performance of services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

(ii) *Example 2.* X is the operator of a residential facility that provides a variety of services to senior citizens who reside on campus. For residents, X offers standard domestic services including housing management and maintenance, meals, laundry, entertainment, and other similar services. In addition, X contracts with local professional healthcare organizations to offer residents a range of medical and health services provided at the facility, including skilled nursing care, physical and occupational therapy, speech-language pathology services, medical social services, medications, medical supplies and equipment used in the facility, ambulance transportation to the nearest supplier of needed services, and dietary counseling. X receives all of its income from residents for the costs associated with residing at the facility. Any health and medical services are billed directly by the healthcare providers to the senior citizens for those professional healthcare services even though those services are provided at the facility. X does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

(iii) *Example 3.* Y operates specialty surgical centers that provide outpatient medical procedures that do not require the patient to remain overnight for recovery or observation following the procedure. Y is a private organization that owns a number of facilities throughout the country. For each facility, Y ensures compliance with state and Federal laws for medical facilities and manages the facility's operations and performs all administrative functions. Y does not employ physicians, nurses, and medical assistants, but enters into agreements with other professional medical organizations or directly with the medical professionals to perform the procedures and provide all medical care. Patients are billed by Y for the facility costs relating to their procedure and by the healthcare professional or their affiliated organization for the actual costs of the procedure conducted by the physician and medical support team. Y does not perform services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section.

(iv) *Example 4.* Z is the developer and the only provider of a patented test used to detect a particular medical condition. Z accepts test orders only from health care professionals (Z's clients), does not have contact with patients, and Z's employees do not diagnose, treat, or manage any aspect of patient care. A, who manages Z's testing operations, is the only employee with an advanced medical degree. All other employees are technical support staff and not healthcare professionals. Z's workers are highly educated, but the skills the workers bring to the job are not often useful for Z's testing methods. In order to perform the duties required by Z, employees receive more than a year of specialized training for working with Z's test, which is of no use to other employers. Upon completion of an ordered test, Z analyses the results and provides its clients a report summarizing the findings. Z does not discuss the report's results, or the patient's diagnosis or treatment with any health care provider or the patient. Z is not informed by the healthcare provider as to the healthcare provider's diagnosis or treatment. Z is not providing services in the field of health within the meaning of section 199A(d)(2) and paragraphs (b)(1)(i) and (b)(2)(ii) of this section or where the principal asset of the trade or business is the reputation or skill of one or more of its employees within the meaning of paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(v) *Example 5.* A, a singer and songwriter, writes and records a song. A is paid a mechanical royalty when the song is licensed or streamed. A is also paid a performance royalty when the recorded song is played publicly. A is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. The royalties that A receives for the song are not eligible for a deduction under section 199A.

(vi) *Example 6.* B is a partner in Movie LLC, a partnership. Movie LLC is a film production company. Movie LLC plans and coordinates film production. Movie LLC shares in the profits of the films that it produces. Therefore, Movie LLC is engaged in the performance of services in an SSTB in the field of performing arts within the meaning of section 199A(d)(2) or paragraphs (b)(1)(v) and (b)(2)(vi) of this section. B is a passive owner in Movie LLC and does not provide any services with respect to Movie LLC. However, because Movie LLC is engaged in an SSTB in the field of performing arts, B's distributive share of the income, gain, deduction, and loss with respect to Movie LLC is not eligible for a deduction under section 199A.

(vii) *Example 7.* C is a partner in Partnership, which solely owns and operates a professional sports team. Partnership employs athletes and sells tickets and broadcast rights for games in which the sports team competes. Partnership sells the broadcast rights to Broadcast LLC, a separate trade or business. Broadcast LLC solely broadcasts the games. Partnership is engaged in the performance of services in an SSTB in the field of athletics within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vii) and (b)(2)(viii) of this section. The tickets sales and the sale of the broadcast rights are both the performance of services in the field of athletics. C is a passive owner in Partnership and C does not provide any services with respect to Partnership or the sports team. However, because Partnership is engaged in an SSTB in the field of athletics, C's distributive share of the income, gain, deduction, and loss with respect to Partnership is not eligible for a deduction under section 199A. Broadcast LLC is not engaged in the performance of services in an SSTB in the field of athletics.

(viii) *Example 8.* D is in the business of providing services that assist unrelated entities in making their personnel structures more efficient. D studies its client's organization and structure and compares it to peers in its industry. D then makes recommendations and provides advice to its client regarding possible changes in the client's personnel structure, including the use of temporary workers. D does not provide any temporary workers to its clients and D's compensation and fees are not affected by whether D's clients used temporary workers. D is engaged in the performance of services in an SSTB in the field of consulting within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

(ix) *Example 9.* E is an individual who owns and operates a temporary worker staffing firm primarily focused on the software consulting industry. Business clients hire E to provide temporary workers that have the necessary technical skills and experience with a variety of business software to provide consulting and advice regarding the proper selection and operation of software most appropriate for the business they are advising. E does not have a technical software engineering background and does not provide software consulting advice herself. E reviews resumes and refers candidates to the client when the client indicates a need for temporary workers. E does not evaluate her clients' needs about whether the client needs workers and does not evaluate the clients' consulting contracts to determine the type of expertise needed. Rather, the client provides E with a job description indicating the required skills for the upcoming consulting project. E is paid a fixed fee for each temporary worker actually hired by the client and receives a bonus if that worker is hired permanently within a year of referral. E's fee is not contingent on the profits of its clients. E is not considered to be engaged in the performance of services in the field of consulting within the meaning of section 199A(d)(2) or (b)(1)(vi) and (b)(2)(vii) of this section.

(x) *Example 10.* F is in the business of licensing software to customers. F discusses and evaluates the customer's software needs with the customer. The taxpayer advises the customer on the particular software products it licenses. F is paid a flat price for the software license. After the customer licenses the software, F helps to implement the software. F is engaged in the trade or business of licensing software and not engaged in an SSTB in the field of consulting within the meaning of section 199A(d)(2) or paragraphs (b)(1)(vi) and (b)(2)(vii) of this section.

(xi) *Example 11.* G is in the business of providing services to assist clients with their finances. G will study a particular client's financial situation, including, the client's present income, savings, and investments, and anticipated future economic and financial needs. Based on this study, G will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. G is engaged in the performance of services in an SSTB in the field of financial services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

(xii) *Example 12.* H is in the business of franchising a brand of personal financial planning offices, which generally provide personal wealth management, retirement planning, and other financial advice services to customers for a fee. H does not provide financial planning services itself. H licenses the right to use the business tradename, other branding intellectual property, and a marketing plan to third-party financial planner franchisees that operate the franchised locations and provide all services to customers. In exchange, the franchisees compensate H based on a fee structure, which includes a one-time fee to acquire the franchise. H is not engaged in the performance of services in the field of financial services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(viii) and (b)(2)(ix) of this section.

(xiii) *Example 13.* J is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. Customers place orders with J to trade securities or commodities based on the taxpayer's recommendations. J's compensation for its services typically is based on completion of the trade orders. J is engaged in an SSTB in the field of brokerage services within the meaning of section 199A(d)(2) or paragraphs (b)(1)(ix) and (b)(2)(x) of this section.

(xiv) *Example 14.* K owns 100% of Corp, an S corporation, which operates a bicycle sales and repair business. Corp has 8 employees, including K.Half of Corp's net income is generated from sales of new and used bicycles and related goods, such as helmets, and bicycle-related equipment.The other half of Corp's net income is generated from bicycle repair servicesperformed by K and Corp's other employees. Corp's assets consist of inventory, fixtures, bicycle repair equipment, and a leasehold on its retail location. Several of the employees and K have worked in the bicycle business for many years, and have acquired substantial skill and reputation in the field. Customers often consult with the employees on the best bicycle for purchase. K is in the business of sales and repairs of bicycles and is not engaged in an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(xv) *Example 15.* L is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to L's skill and reputation as a chef, L receives an endorsement fee of $500,000 for the use of L's name on a line of cooking utensils and cookware. L is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, L is also in the trade or business of receiving endorsement income. L's trade or business consisting of the receipt of the endorsement fee for L's skill and/or reputation is an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(xvi) *Example 16.* M is a well-known actor. M entered into a partnership with Shoe Company, in which M contributed her likeness and the use of her name to the partnership in exchange for a 50% interest in the partnership and a guaranteed payment. M's trade or business consisting of the receipt of the partnership interest and the corresponding distributive share with respect to the partnership interest for M's likeness and the use of her name is an SSTB within the meaning of section 199A(d)(2) or paragraphs (b)(1)(xiii) and (b)(2)(xiv) of this section.

(c) *Special rules*—(1) *De minimis rule*—(i) *Gross receipts of $25 million or less.* For a trade or business with gross receipts of $25 million or less for the taxable year, a trade or business is not an SSTB if less than 10 percent of the gross receipts of the trade or business are attributable to the performance of services in a field described in paragraph (b) of this section. For purposes of determining whether this 10 percent test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field.

(ii) *Gross receipts of greater than $25 million.* For a trade or business with gross receipts of greater than $25 million for the taxable year, the rules of paragraph (c)(1)(i) of this section are applied by substituting ''5 percent'' for ''10 percent'' each place it appears.

(iii) *Examples.* The following examples illustrate the provisions of paragraph (c)(1) of this section.

(A) *Example 1.* Landscape LLC sells lawn care and landscaping equipment and also provides advice and counsel on landscape design for large office parks and residential buildings. The landscape design services include advice on the selection and placement of trees, shrubs, and flowers and are considered to be the performance of services in the field of consulting under paragraphs (b)(1)(vi) and (b)(2)(vii) of this section. Landscape LLC separately invoices for its landscape design services and does not sell the trees, shrubs, or flowers it recommends for use in the landscape design. Landscape LLC maintains one set of books and records and treats the equipment sales and design services as a single trade or business for purposes of sections 162 and 199A. Landscape LLC has gross receipts of $2 million. $250,000 of the gross receipts is attributable to the landscape design services, an SSTB. Because the gross receipts from the consulting services exceed 10 percent of Landscape LLC's total gross receipts, the entirety of Landscape LLC's trade or business is considered an SSTB.

(B) *Example 2.* Animal Care LLC provides veterinarian services performed by licensed staff and also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health under paragraphs (b)(1)(i) and (b)(2)(ii) of this section. Animal Care LLC separately invoices for its veterinarian services and the sale of its organic dog food. Animal Care LLC maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. Animal Care LLC also has separate employees who are unaffiliated with the veterinary clinic and who only work on the formulation, marketing, sales, and distribution of the organic dog food products. Animal Care LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of section 162 and 199A. Animal Care LLC has gross receipts of $3,000,000. $1,000,000 of the gross receipts is attributable to the veterinary services, an SSTB. Although the gross receipts from the services in the field of health exceed 10 percent of Animal Care LLC's total gross receipts, the dog food development and sales business is not considered an SSTB due to the fact that the veterinary practice and the dog food development and sales are separate trades or businesses under section 162.

(2) *Services or property provided to an SSTB*—(i) *In general.* If a trade or business provides property or services to an SSTB within the meaning of this section and there is 50 percent or more common ownership of the trades or businesses, that portion of the trade or business of providing property or services to the 50 percent or more commonly-owned SSTB will be treated as a separate SSTB with respect to the related parties.

(ii) *50 percent or more common ownership.* For purposes of paragraph (c)(2)(i) and (ii) of this section, 50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of sections 267(b) or 707(b).

(iii) *Examples.* The following examples illustrate the provisions of paragraph (c)(2) of this section.

(A) *Example 1.* Law Firm is a partnership that provides legal services to clients, owns its own office building and employs its own administrative staff. Law Firm divides into three partnerships. Partnership 1 performs legal services to clients. Partnership 2 owns the office building and rents the entire building to Partnership 1. Partnership 3 employs the administrative staff and through a contract with Partnership 1 provides administrative services to Partnership 1 in exchange for fees. All three of the partnerships are owned by the same people (the original owners of Law Firm). Because Partnership 2 provides all of its property to Partnership 1, and Partnership 3 provides all of its services to Partnership 1, Partnerships 2 and 3 will each be treated as an SSTB under paragraph (c)(2) of this section.

(B) *Example 2.* Assume the same facts as in Example 1 of this paragraph (c)(2), except that Partnership 2, which owns the office building, rents 50 percent of the building to Partnership 1, which provides legal services, and the other 50 percent to various unrelated third party tenants. Because Partnership 2 is owned by the same people as Partnership 1, the portion of Partnership 2's leasing activity related to the lease of the building to Partnership 1 will be treated as a separate SSTB. The remaining 50 percent of Partnership 2's leasing activity will not be treated as an SSTB.

(d) *Trade or business of performing services as an employee*—(1) *In general.* The trade or business of performing services as an employee is not a trade or business for purposes of section 199A and the regulations thereunder. Therefore, no items of income, gain, deduction, and loss from the trade or business of performing services as an employee constitute QBI within the meaning of section 199A and §1.199A–3. Except as provided in paragraph (d)(3) of this section, income from the trade or business of performing services as an employee refers to all wages (within the meaning of section 3401(a)) and other income earned in a capacity as an employee, including payments described in §1.6041–2(a)(1) (other than payments to individuals described in section 3121(d)(3)) and §1.6041–2(b)(1).

(2) *Employer's Federal employment tax classification of employee immaterial.* For purposes of determining whether wages are earned in a capacity as an employee as provided in paragraph (d)(1) of this section, the treatment of an employee by an employer as anything other than an employee for Federal employment tax purposes is immaterial. Thus, if a worker should be properly classified as an employee, it is of no consequence that the employee is treated as a non-employee by the employer for Federal employment tax purposes.

(3) *Presumption that former employees are still employees*—(i) *Presumption.* Solely for purposes of section 199A(d)(1)(B) and paragraph (d)(1) of this section, an individual that was properly treated as an employee for Federal employment tax purposes by the person to which he or she provided services and who is subsequently treated as other than an employee by such person with regard to the provision of substantially the same services directly or indirectly to the person (or a related person), is presumed, for three years after ceasing to be treated as an employee for Federal employment tax purposes, to be in the trade or business of performing services as an employee with regard to such services. As provided in paragraph (d)(3)(ii) of this section, this presumption may be rebutted upon a showing by the individual that, under Federal tax law, regulations, and principles (including common-law employee classification rules), the individual is performing services in a capacity other than as an employee. This presumption applies regardless of whether the individual provides services directly or indirectly through an entity or entities.

(ii) *Rebuttal of presumption.* Upon notice from the IRS, an individual rebuts the presumption in paragraph (d)(3)(i) of this section by providing records, such as contracts or partnership agreements, that provide sufficient evidence to corroborate the individual's status as a non-employee.

(iii) *Examples.* The following examples illustrate the provision of paragraph (d)(3) of this section. Unless otherwise provided, the individual in each example has taxable income in excess of the threshold amount.

(A) *Example 1.* A is employed by PRS, a partnership for Federal tax purposes, as a fulltime employee and is treated as such for Federal employment tax purposes. A quits his job for PRS and enters into a contract with PRS under which A provides substantially the same services that A previously provided to PRS in A's capacity as an employee. Because A was treated as an employee for services he provided to PRS, and now is no longer treated as an employee with regard to such services, A is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with regard to his services performed for PRS. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including the common-law employee classification rules), A is not an employee, any amounts paid by PRS to A with respect to such services will not be QBI for purposes of section 199A. The presumption would apply even if, instead of contracting directly with PRS, A formed a disregarded entity, or a passthrough entity, and the entity entered into the contract with PRS.

(B) *Example 2.* C is an attorney employed as an associate in a law firm (Law Firm 1) and was treated as such for Federal employment tax purposes. C and the other associates in Law Firm 1 have taxable income below the threshold amount. Law Firm 1 terminates its employment relationship with C and its other associates. C and the other former associates form a new partnership, Law Firm 2, which contracts to perform legal services for Law Firm 1. Therefore, in form, C is now a partner in Law Firm 2 which earns income from providing legal services to Law Firm 1. C continues to provide substantially the same legal services to Law Firm 1 and its clients. Because C was previously treated as an employee for services she provided to Law Firm 1, and now is no longer treated as an employee with regard to such services, C is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services C provides to Law Firm 1 indirectly through Law Firm 2. Unless the presumption is rebutted with a showing that, under Federal tax law, regulations, and principles (including common-law employee classification rules), C is not an employee, C's distributive share of Law Firm 2 income (including any guaranteed payments) will not be QBI for purposes of section 199A. The results in this example would not change if, instead of contracting with Law Firm 1, Law Firm 2 was instead admitted as a partner in Law Firm 1.

(C) *Example 3.* E is an engineer employed as a senior project engineer in an engineering firm, Engineering Firm. Engineering Firm is a partnership for Federal tax purposes and structured such that after 10 years, senior project engineers are considered for partner if certain career milestones are met. After 10 years, E meets those career milestones and is admitted as a partner in Engineering Firm. As a partner in Engineering Firm, E shares in the net profits of Engineering Firm, and also otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner. E is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services E provides to Engineering Firm. However, E is able to rebut the presumption by showing that E became a partner in Engineering Firm as a career milestone, shares in the overall net profits in Engineering Firm, and otherwise satisfies the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

(D) *Example 4.* F is a financial advisor employed by a financial advisory firm, Advisory Firm, a partnership for Federal tax purposes, as a fulltime employee and is treated as such for Federal employment tax purposes. F has taxable income below the threshold amount. Advisory Firm is a partnership and offers F the opportunity to be admitted as a partner. F elects to be admitted as a partner to Advisory Firm and is admitted as a partner to Advisory Firm. As a partner in Advisory Firm, F shares in the net profits of Advisory Firm, is obligated to Advisory Firm in ways that F was not previously obligated as an employee, is no longer entitled to certain benefits available only to employees of Advisory Firm, and has materially modified his relationship with Advisory Firm. F's share of net profits is not subject to a floor or capped at a dollar amount. F is presumed (solely for purposes of section 199A(d)(1)(B) and paragraphs (a)(3) and (d) of this section) to be in the trade or business of performing services as an employee with respect to the services F provides to Advisory Firm. However, F is able to rebut the presumption by showing that F became a partner in Advisory Firm by sharing in the profits of Advisory Firm, materially modifying F's relationship with Advisory Firm, and otherwise satisfying the requirements under Federal tax law, regulations, and principles (including common-law employee classification rules) to be respected as a partner.

(e) *Applicability date*—(1) *General rule.* Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exceptions*–(i) *Anti-abuse rules.* The provisions of paragraphs (c)(2) and (d)(3) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE.* For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

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§ 1.199A–6 Relevant passthrough entities (RPEs), publicly traded partnerships (PTPs), trusts, and estates.

(a) *Overview.* This section provides special rules for RPEs, PTPs, trusts, and estates necessary for the computation of the section 199A deduction of their owners or beneficiaries. Paragraph (b) of this section provides computational and reporting rules for RPEs necessary for individuals who own interests in RPEs to calculate their section 199A deduction. Paragraph (c) of this section provides computational and reporting rules for PTPs necessary for individuals who own interests in PTPs to calculate their section 199A deduction. Paragraph (d) of this section provides computational and reporting rules for trusts (other than grantor trusts) and estates necessary for their beneficiaries to calculate their section 199A deduction.

(b) *Computational and reporting rules for RPEs*—(1) *In general.* An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their section 199A deduction.

(2) *Computational rules.* Using the following four rules, an RPE must determine the items necessary for individuals who own interests in the RPE to calculate their section 199A deduction under §1.199A–1(c) or (d). An RPE that chooses to aggregate trades or businesses under the rules of §1.199A–4 may determine these items for the aggregated trade or business.

(i) First, the RPE must determine if it is engaged in one or more trades or businesses. The RPE must also determine whether any of its trades or businesses is an SSTB under the rules of §1.199A–5.

(ii) Second, the RPE must apply the rules in §1.199A–3 to determine the QBI for each trade or business engaged in directly.

(iii) Third, the RPE must apply the rules in §1.199A–2 to determine the W–2 wages and UBIA of qualified property for each trade or business engaged in directly.

(iv) Fourth, the RPE must determine whether it has any qualified REIT dividends as defined in §1.199A–3(c)(1) earned directly or through another RPE. The RPE must also determine the amount of qualified PTP income as defined in §1.199A–3(c)(2) earned directly or indirectly through investments in PTPs.

(3) *Reporting rules for RPEs*—(i) *Trade or business directly engaged in.* An RPE must separately identify and report on the Schedule K–1 issued to its owners for any trade or business (including an aggregated trade or business) engaged in directly by the RPE—

(A) Each owner's allocable share of QBI, W–2 wages, and UBIA of qualified property attributable to each such trade or business; and

(B) Whether any of the trades or businesses described in paragraph (b)(3)(i) of this section is an SSTB.

(ii) *Other items.* An RPE must also report on an attachment to the Schedule K–1, any QBI, W–2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest. The RPE must also report each owner's allocated share of any qualified REIT dividends received by the RPE (including through another RPE) as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE). Such information can be reported on an amended or late filed return to the extent that the period of limitations remains open.

(iii) *Failure to report information.* If an RPE fails to separately identify or report on the Schedule K–1 (or any attachments thereto) issued to an owner an item described in paragraph (b)(3)(i) of this section, the owner's share (and the share of any upper-tier indirect owner) of each unreported item of positive QBI, W–2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero.

(c) *Computational and reporting rules for PTPs*—(1) *Computational rules.* Each PTP must determine its QBI under the rules of § 1.199A–3 for each trade or business in which the PTP is engaged in directly. The PTP must also determine whether any of the trades or businesses it is engaged in directly is an SSTB.

(2) *Reporting rules.* Each PTP is required to separately identify and report the information described in paragraph (c)(1) of this section on Schedules K–1 issued to its partners. Each PTP must also determine and report any qualified REIT dividends or qualified PTP income or loss received by the PTP including through an RPE, a REIT, or another PTP. A PTP is not required to determine or report W–2 wages or the UBIA of qualified property attributable to trades or businesses it is engaged in directly.

(d) *Application to trusts, estates, and beneficiaries*—(1) *In general.* A trust or estate computes its section 199A deduction based on the QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income that are allocated to the trust or estate. An individual beneficiary of a trust or estate takes into account any QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income allocated from a trust or estate in calculating the beneficiary's section 199A deduction, in the same manner as though the items had been allocated from an RPE. For purposes of this section and §§ 1.199A–1 through 1.199A–5, a trust or estate is treated as an RPE to the extent it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains the QBI and other items.

(2) *Grantor trusts.* To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or other person.

(3) *Non-grantor trusts and estates*—(i) *Calculation at entity level.* A trust or estate must calculate its QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. The QBI of a trust or estate must be computed by allocating qualified items of deduction described in section 199A(c)(3) in accordance with the classification of those deductions under § 1.652(b)–3(a), and deductions not directly attributable within the meaning of § 1.652(b)–3(b) (other deductions) are allocated in a manner consistent with the rules in § 1.652(b)–3(b). Any depletion and depreciation deductions described in section 642(e) and any amortization deductions described in section 642(f) that otherwise are properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

(ii) *Allocation among trust or estate and beneficiaries.* The QBI (including any amounts that may be less than zero as calculated at the trust or estate level), W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust's or estate's *distributable net income (DNI),* as defined by section 643(a), for the taxable year that is distributed or required to be distributed to the beneficiary or is retained by the trust or estate. For this purpose, the trust's or estate's DNI is determined with regard to the separate share rule of section 663(c), but without regard to section 199A. If the trust or estate has no DNI for the taxable year, any QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income are allocated entirely to the trust or estate.

(iii) *Separate shares.* In the case of a trust or estate described in section 663(c) with substantially separate and independent shares for multiple beneficiaries, such trust or estate will be treated as a single trust or estate for purposes of determining whether the taxable income of the trust or estate exceeds the threshold amount; determining taxable income, net capital gain, net QBI, W–2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income for each trade or business of the trust and estate; and computing the W–2 wage and UBIA of qualified property limitations. The allocation of these items to the separate shares of a trust or estate will be governed by the rules under §§1.663(c)–1 through 1.663(c)–5, as they may be adjusted or clarified by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(iv) *Threshold amount.* The threshold amount applicable to a trust or estate is $157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be $157,500 increased by the cost-of-living adjustment as outlined in §1.199A–1(b)(12). For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, the taxable income of the trust or estate is determined after taking into account any distribution deduction under sections 651 or 661.

(v) *Charitable remainder trusts.* A charitable remainder trust described in section 664 is not entitled to and does not calculate a section 199A deduction, and the threshold amount described in section 199A(e)(2) does not apply to the trust. However, any taxable recipient of a unitrust or annuity amount from the trust must determine and apply the recipient's own threshold amount for purposes of section 199A taking into account any annuity or unitrust amounts received from the trust. A recipient of a unitrust or annuity amount from a trust may take into account QBI, qualified REIT dividends, or qualified PTP income for purposes of determining the recipient's section 199A deduction for the taxable year to the extent that the unitrust or annuity amount distributed to such recipient consists of such section 199A items under §1.664–1(d). For example, if a charitable remainder trust has investment income of $500, qualified dividend income of $200, and qualified REIT dividends of $1,000, and distributes $1,000 to the recipient, the trust would be treated as having income in two classes within the category of income, described in §1.664–1(d)(1)(i)(*a*)(*1*), for purposes of §1.664–1(d)(1)(ii)(*b*). Because the annuity amount first carries out income in the class subject to the highest income tax rate, the entire annuity payment comes from the class with the investment income and qualified REIT dividends. Thus, the charitable remainder trust would be treated as distributing a proportionate amount of the investment income ($500 / (1,000 + 500) * 1,000 = $333) and qualified REIT dividends ($1000 / (1,000 + 500) * 1000 = $667) because the investment income and qualified REIT dividends are taxed at the same rate and within the same class, which is higher than the rate of tax for the qualified dividend income in a separate class. The charitable remainder trust in this example would not be treated as distributing any of the qualified dividend income until it distributed all the investment income and qualified REIT dividends (more than $1,500 in total) to the recipient. To the extent that a trust is treated as distributing QBI, qualified REIT dividends, or qualified PTP income to more than one unitrust or annuity recipient in the taxable year, the distribution of such income will be treated as made to the recipients proportionately, based on their respective shares of total QBI, qualified REIT dividends, or qualified PTP income distributed for that year. The trust allocates and reports any W–2 wages or UBIA of qualified property to the taxable recipient of the annuity or unitrust interest based on each recipient's share of the trust's total QBI (whether or not distributed) for that taxable year. Accordingly, if 10 percent of the QBI of a charitable remainder trust is distributed to the recipient and 90 percent of the QBI is retained by the trust, 10 percent of the W–2 wages and UBIA of qualified property is allocated and reported to the recipient and 90 percent of the W–2 wages and UBIA of qualified property is treated as retained by the trust. However, any W–2 wages retained by the trust cannot be used to compute W–2 wages in a subsequent taxable year for section 199A purposes. Any QBI, qualified REIT dividends, or qualified PTP income of the trust that is unrelated business taxable income is subject to excise tax and that tax must be allocated to the corpus of the trust under §1.664–1(c).

(vi) *Electing small business trusts.* An electing small business trust (ESBT) is entitled to the deduction under section 199A. Any section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust. *See* §1.641(c)–1.

(vii) *Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount.* A trust formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A. *See also* §1.643(f)–1 of the regulations.

(viii) *Example.* The following example illustrates the application of paragraph (d) of this section.

(A) *Example*—(*1*) *Computation of DNI and inclusion and deduction amounts*—(*i*) *Trust's distributive share of partnership items.* Trust, an irrevocable testamentary complex trust, is a 25% partner in PRS, a family partnership that operates a restaurant that generates QBI and W–2 wages. A and B, Trust's beneficiaries, own the remaining 75% of PRS directly. In 2018, PRS properly allocates gross income from the restaurant of $55,000, and expenses directly allocable to the restaurant of $45,000 (including W–2 wages of $25,000, and miscellaneous expenses of $20,000) to Trust. These items are properly included in Trust's DNI. PRS distributes $10,000 of cash to Trust in 2018.

(*ii*) *Trust's activities.* In addition to its interest in PRS, Trust also operates a family bakery conducted through an LLC wholly-owned by the Trust that is treated as a disregarded entity. In 2018, the bakery produces $100,000 of gross income and $155,000 of expenses directly allocable to operation of the bakery (including W–2 wages of $50,000, rental expense of $75,000, miscellaneous expenses of $25,000, and depreciation deductions of $5,000). (The net loss from the bakery operations is not subject to any loss disallowance provisions outside of section 199A.) Trust maintains a reserve of $5,000 for depreciation. Trust also has $125,000 of UBIA of qualified property in the bakery. For purposes of computing its section 199A deduction, Trust and its beneficiaries have properly chosen to aggregate the family restaurant conducted through PRS with the bakery conducted directly by Trust under §1.199A–4. Trust also owns various investment assets that produce portfolio-type income consisting of dividends ($25,000), interest ($15,000), and tax-exempt interest ($15,000). Accordingly, Trust has the following items which are properly included in Trust's DNI:

TABLE 1 TO PARAGRAPH (d)(3)(viii)(A)(*1*)(*ii*)

Interest Income	15,000
Dividends	25,000
Tax-exempt interest	15,000
Net business loss from PRS and bakery	(45,000)
Trustee commissions	3,000
State and local taxes	5,000

(*iii*) *Allocation of deductions under §1.652(b)–3 (Directly attributable expenses).* In computing Trust's DNI for the taxable year, the distributive share of expenses of PRS are directly attributable under § 1.652(b)–3(a) to the distributive share of income of PRS. Accordingly, Trust has gross business income of $155,000 ($55,000 from PRS and $100,000 from the bakery) and direct business expenses of $200,000 ($45,000 from PRS and $155,000 from the bakery). In addition, $1,000 of the trustee commissions and $1,000 of state and local taxes are directly attributable under § 1.652(b)–3(a) to Trust's business income. Accordingly, Trust has excess business deductions of $47,000. Pursuant to its authority recognized under § 1.652(b)–3(d), Trust allocates the $47,000 excess business deductions as follows: $15,000 to the interest income, resulting in $0 interest income, $25,000 to the dividends, resulting in $0 dividend income, and $7,000 to the tax exempt interest.

(*iv*) *Allocation of deductions under § 1.652(b)–3 (Non-directly attributable expenses)*. The trustee must allocate the sum of the balance of the trustee commissions ($2,000) and state and local taxes ($4,000) to Trust's remaining tax-exempt interest income, resulting in $2,000 of tax exempt interest.

(*v*) *Amounts included in taxable income*. For 2018, Trust has DNI of $2,000. Pursuant to Trust's governing instrument, Trustee distributes 50%, or $1,000, of that DNI to A, an individual who is a discretionary beneficiary of Trust. In addition, Trustee is required to distribute 25%, or $500, of that DNI to B, a current income beneficiary of Trust. Trust retains the remaining 25% of DNI. Consequently, with respect to the $1,000 distribution A receives from Trust, A properly excludes $1,000 of tax-exempt interest income under section 662(b). With respect to the $500 distribution B receives from Trust, B properly excludes $500 of tax exempt interest income under section 662(b). Because the DNI consists entirely of tax-exempt income, Trust deducts $0 under section 661 with respect to the distributions to A and B.

(*2*) *Section 199A deduction*—(*i*) *Trust's W–2 wages and QBI*. For the 2018 taxable year, prior to allocating the beneficiaries' shares of the section 199A items, Trust has $75,000 ($25,000 from PRS + $50,000 of Trust) of W–2 wages. Trust also has $125,000 of UBIA of qualified property. Trust has negative QBI of ($47,000) ($155,000 gross income from aggregated businesses less the sum of $200,000 direct expenses from aggregated businesses and $2,000 directly attributable business expenses from Trust under the rules of § 1.652(b)–3(a)).

(*ii*) *A's Section 199A deduction computation*. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has W–2 wages from Trust of $37,500. A also has W–2 wages of $2,500 from a trade or business outside of Trust (computed without regard to A's interest in Trust), which A has properly aggregated under § 1.199A–4 with the Trust's trade or businesses (the family's restaurant and bakery), for a total of $40,000 of W–2 wages from the aggregate trade or businesses. A also has $62,500 of UBIA from Trust and $25,000 of UBIA of qualified property from the trade or business outside of Trust for $87,500 of total UBIA of qualified property. A has $100,000 of QBI from the non-Trust trade or businesses in which A owns an interest. Because the $1,000 Trust distribution to A equals one-half of Trust's DNI, A has (negative) QBI from Trust of ($23,500). A's total QBI is determined by combining the $100,000 QBI from non-Trust sources with the ($23,500) QBI from Trust for a total of $76,500 of QBI. Assume that A's taxable income is $357,500, which exceeds A's applicable threshold amount for 2018 by $200,000. A's tentative deductible amount is $15,300 (20% × $76,500 of QBI), limited to the greater of (i) $20,000 (50% × $40,000 of W–2 wages), or (ii) $12,187.50 ($10,000, 25% × $40,000 of W–2 wages, plus $2,187.50, 2.5% × $87,500 of UBIA of qualified property). A's section 199A deduction is equal to the lesser of $15,300, or $71,500 (20% × $357,500 of taxable income). Accordingly, A's section 199A deduction for 2018 is $15,300.

(*iii*) *B's Section 199A deduction computation*. For 2018, B's taxable income is below the threshold amount so B is not subject to the W–2 wage limitation. Because the $500 Trust distribution to B equals one-quarter of Trust's DNI, B has a total of ($11,750) of QBI. B also has no QBI from non-Trust trades or businesses, so B has a total of ($11,750) of QBI. Accordingly, B's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of B pursuant to section 199A(c)(2).

(*iv*) *Trust's Section 199A deduction computation*. For 2018, Trust's taxable income is below the threshold amount so it is not subject to the W–2 wage limitation. Because Trust retained 25% of Trust's DNI, Trust is allocated 25% of its QBI, which is ($11,750). Trust's section 199A deduction for 2018 is zero. The ($11,750) of QBI is carried over to 2019 as a loss from a qualified business in the hands of Trust pursuant to section 199A(c)(2).

(B) [Reserved]

(e) *Applicability date*—(1) *General rule*. Except as provided in paragraph (e)(2) of this section, the provisions of this section apply to taxable years ending after February 8, 2019.

(2) *Exceptions*—(i) *Anti-abuse rules*. The provisions of paragraph (d)(3)(vii) of this section apply to taxable years ending after December 22, 2017.

(ii) *Non-calendar year RPE*. For purposes of determining QBI, W–2 wages, UBIA of qualified property, and the aggregate amount of qualified REIT dividends and qualified PTP income, if an individual receives any of these items from an RPE with a taxable year that begins before January 1, 2018, and ends after December 31, 2017, such items are treated as having been incurred by the individual during the individual's taxable year in which or with which such RPE taxable year ends.

(iii) *Separate shares*. The provisions of paragraph (d)(3)(iii) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (d)(3)(iii) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (d)(3)(iii) of this section for each such year.

(iv) *Charitable remainder trusts*. The provisions of paragraph (d)(3)(v) of this section apply to taxable years beginning after August 24, 2020. Taxpayers may choose to apply the rules in paragraph (d) of this section for taxable years beginning on or before August 24, 2020, so long as the taxpayers consistently apply the rules in paragraph (d)(3)(v) of this section for each such year.

[T.D. 9847, 84 FR 3012, Feb. 8, 2019, as amended by T.D. 9899, 85 FR 38067, June 25, 2020]

§ 1.199A–7 Section 199A(a) Rules for Cooperatives and their patrons.

(a) *Overview*—(1) *In general*. This section provides guidance and special rules on the application of the rules of §§ 1.199A–1 through 1.199A–6 regarding the deduction for qualified business income (QBI) under section 199A(a) (section 199A(a) deduction) of the Internal Revenue Code (Code) by patrons (patrons) of cooperatives to which Part I of subchapter T of chapter 1 of the Code (subchapter T) applies (Cooperatives). Unless otherwise provided in this section, all the rules in §§ 1.199A–1 through 1.199A–6 relating to calculating the section 199A(a) deduction apply to patrons and Cooperatives. Paragraph (b) of this section provides special rules for patrons relating to trades or businesses. Paragraph (c) of this section provides special rules for patrons and Cooperatives relating to the definition of QBI. Paragraph (d) of this section provides special rules for patrons and Cooperatives relating to specified service trades or businesses (SSTBs). Paragraph (e) of this section provides special rules for patrons relating to the statutory limitations based on W–2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property. Paragraph (f) of this section provides special rules for specified agricultural or horticultural cooperatives (Specified Cooperatives) and paragraph (g) of this section provides examples for Specified Cooperatives and their patrons. Paragraph (h) of this section sets forth the applicability date of this section and a special transition rule relating to Specified Cooperatives and their patrons.

(2) *At patron level*. The section 199A(a) deduction is applied at the patron level, and patrons who are individuals (as defined in § 1.199A–1(a)(2)) may take the section 199A(a) deduction.

(3) *Definitions*. For purposes of section 199A and § 1.199A–7, the following definitions apply—

(i) *Individual* is defined in § 1.199A–1(a)(2).

(ii) *Patron* is defined in § 1.1388–1(e).

(iii) *Patronage and nonpatronage* is defined in § 1.1388–1(f).

(iv) *Relevant Passthrough Entity (RPE)* is defined in § 1.199A–1(a)(9).

(v) *Qualified payment* is defined in § 1.199A–8(d)(2)(ii).

(vi) *Specified Cooperative* is defined in § 1.199A–8(a)(2) and is a subset of Cooperatives defined in § 1.199A–7(a)(1).

(b) *Trade or business.* A patron (whether the patron is an RPE or an individual), and not a Cooperative, must determine whether it has one or more trades or businesses that it directly conducts as defined in § 1.199A–1(b)(14). To the extent a patron operating a trade or business has income directly from that business, the patron must follow the rules of §§ 1.199A–1 through 1.199A–6 to calculate the section 199A(a) deduction. Patronage dividends or similar payments are considered to be generated from the trade or business the Cooperative conducts on behalf of or with the patron. A Cooperative that distributes patronage dividends or similar payments, as described in paragraph (c)(1) of this section, must determine and report information to its patrons relating to qualified items of income, gain, deduction, and loss in accordance with paragraphs (c)(3) and (d)(3) of this section. A patron that receives patronage dividends or similar payments, as described in paragraph (c)(1) of this section, from a Cooperative must follow the rules of paragraphs (c) through (e) of this section to calculate the section 199A(a) deduction.

(c) *Qualified Business Income*—(1) *In general.* QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of section 199A(c)(3) and § 1.199A–3(b). A qualified item of income includes distributions for which the Cooperative is allowed a deduction under section 1382(b) and (c)(2) (including patronage dividends or similar payments, such as money, property, qualified written notices of allocations, and qualified per-unit retain certificates, as well as money or property paid in redemption of a nonqualified written notice of allocation (collectively patronage dividends or similar payments)), provided such distribution is otherwise a qualified item of income, gain, deduction, or loss. *See* special rule in paragraph (d)(3) of this section relating to SSTBs that may affect QBI.

(2) *QBI determinations made by patron.* A patron must determine QBI for each trade or business it directly conducts. In situations where the patron receives distributions described in paragraph (c)(1) of this section, the Cooperative must determine whether those distributions include qualified items of income, gain, deduction, and loss as determined under rules of section 199A(c)(3) and § 1.199A–3(b). These distributions may be included in the QBI of the patron's trade or business to the extent that:

(i) The distributions are related to the patron's trade or business as defined in § 1.199A–1(b)(14);

(ii) The distributions are qualified items of income, gain, deduction, and loss as determined under rules of section 199A(c)(3) and § 1.199A–3(b) at the Cooperative's trade or business level;

(iii) The distributions are not items from an SSTB as defined in section 199A(d)(2) at the Cooperative's trade or business level (except as permitted by the threshold rules in section 199A(d)(3) and § 1.199A–5(a)(2)); and

(iv) Certain information is reported by the Cooperative about these payments as provided in paragraphs (c)(3) and (d)(3) of this section.

(3) *Qualified items of income, gain, deduction, and loss determinations made and reported by Cooperatives.* In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss as determined under the rules of section 199A(c)(3) and § 1.199A–3(b) in those distributions. A patron must determine whether these qualified items relate to one or more trades or businesses that it directly conducts as defined in § 1.199A–1(b)(14). Pursuant to this paragraph (c)(3), the Cooperative must report the net amount of qualified items with respect to non-SSTBs of the Cooperative in the distributions made to the patron on an attachment to or on the Form 1099–PATR, Taxable Distributions Received From Cooperatives, (or any successor

form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report on or before the due date of the Form 1099–PATR the amount of such qualified items of income, gain, deduction, and loss in the distributions to the patron, the amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero. *See* special rule in paragraph (d)(3) of this section relating to reporting of qualified items of income, gain, deduction, and loss with respect to SSTBs of the Cooperative.

(d) *Specified Service Trades or Businesses*—(1) *In general.* This section provides guidance on the determination of SSTBs as defined in section 199A(d)(2) and §1.199A–5. Unless otherwise provided in this section, all of the rules in §1.199A–5 relating to SSTBs apply to patrons of Cooperatives.

(2) *SSTB determinations made by patron.* A patron (whether an RPE or an individual) must determine whether each trade or business it directly conducts is an SSTB.

(3) *SSTB determinations made and reported by Cooperatives*—(i) *In general.* In the case of a Cooperative that makes distributions described in paragraph (c)(1) of this section to a patron, the Cooperative must determine the amount of qualified items of income, gain, deduction, and loss as determined under the rules of section 199A(c)(3) and §1.199A–3(b) with respect to SSTBs directly conducted by the Cooperative. A patron must determine whether these qualified items relate to one or more trades or businesses that it directly conducts as defined in §1.199A–1(b)(14). The Cooperative must report the net amount of qualified items with respect to the SSTBs of the Cooperative in the distributions made to the patron on an attachment to or on the Form 1099–PATR, Taxable Distributions Received from Cooperatives, (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form. If the Cooperative does not report the amount on or before the due date of the Form 1099–PATR, then only the amount that a Cooperative reports as qualified items of income, gain, deduction, and loss under §1.199A–7(c)(3) may be included in the patron's QBI, and the remaining amount of distributions from the Cooperative that may be included in the patron's QBI is presumed to be zero.

(ii) *Patron allocation of expenses paid to Cooperative for SSTB items of income reported by Cooperative*—(A) *In general.* When a Cooperative reports SSTB items to a patron, a patron may allocate a deductible expense that was paid to the Cooperative in connection with the patron's qualified trade or business between a patron's qualified trade or business income and the SSTB income reported to it by the Cooperative only if the SSTB income directly relates to the deductible expense. A patron can allocate the deductible expense paid by the patron to the Cooperative only up to the amount of SSTB income reported by the Cooperative.

(B) *Example. Patron allocating expenses between qualified trade or business and SSTB income from a Cooperative.* (*1*) Cooperative provides to its patrons a service that is an SSTB under section 199A(d)(2). P, a patron, runs a qualified trade or business under section 199A(d)(1) and incurs expenses for the service from the Cooperative in P's qualified trade or business. P pays the Cooperative $1,000 for the service. Cooperative later pays P a patronage dividend of $50 related to the service.

(*2*) Cooperative reports the $50 as SSTB income on the Form 1099–PATR issued to P.

(*3*) Since P's deductible expense for services from the Cooperative was in connection with a qualified trade or business and the SSTB income directly relates to that expense, P may allocate the expense under paragraph (d)(3)(ii) of this section. Accordingly, $50 of the $1,000 expense is allocated to P's SSTB income, and $950 of the expense is allocated to P's qualified trade or business and is included in P's QBI calculation.

(e) *W–2 wages and unadjusted basis immediately after acquisition of qualified property*—(1) *In general.* This section provides guidance on calculating a trade or business's W–2 wages and the UBIA of qualified property properly allocable to QBI.

(2) *Determinations made by patron.* The determination of W–2 wages and UBIA

of qualified property must be made for each trade or business by the patron (whether an RPE or individual) that directly conducts the trade or business before applying the aggregation rules of §1.199A–4. Unlike RPEs, Cooperatives do not compute and allocate their W–2 wages and UBIA of qualified property to patrons.

(f) *Special rules for patrons of Specified Cooperatives*—(1) *Section 199A(b)(7) reduction*. A patron of a Specified Cooperative that receives a qualified payment must reduce its section 199A(a) deduction as provided in §1.199A–1(e)(7). This reduction applies whether the Specified Cooperative passes through all, some, or none of the Specified Cooperative's section 199A(g) deduction to the patron in that taxable year. The rules relating to the section 199A(g) deduction can be found in §§1.199A–8 through 1.199A–12.

(2) *Reduction calculation*—(i) *Allocation method*. If in any taxable year, a patron receives income or gain related to qualified payments and income or gain that is not related to qualified payments in a trade or business, the patron must allocate the income or gain and related deductions, losses and W–2 wages using a reasonable method based on all the facts and circumstances for purposes of calculating the reduction in §1.199A–1(e)(7). Different reasonable methods may be used for different items and related deductions of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one taxable year of the patron to another, and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations under this paragraph (f)(2)(i).

(ii) *Safe harbor*. A patron with taxable income under the threshold amount set forth in section 199A(e)(2) is eligible to use the safe harbor set forth in this paragraph (f)(2)(ii) to apportion its deductions, losses and W–2 wages instead of the allocation method set forth in paragraph (f)(2)(i) of this section for any taxable year in which the patron receives income or gain related to qualified payments and income or gain not related to qualified payments in a trade or business. Under the safe harbor the patron may apportion its deductions, losses and W–2 wages ratably between income or gain related to qualified payments and income or gain that is not related to qualified payments for purposes of calculating the reduction in paragraph (f)(1) of this section. Accordingly, the amount of deductions and losses apportioned to determine QBI allocable to qualified payments is equal to the proportion of the total deductions and losses that the amount of income or gain related to qualified payments bears to total income or gain used to determine QBI. The same proportion applies to determine the amount of W–2 wages allocable to the portion of the trade or business that received qualified payments.

(3) *Qualified payments notice requirement*. A Specified Cooperative must report the amount of the qualified payments made to the eligible taxpayer, as defined in section 199A(g)(2)(D), on an attachment to or on the Form 1099–PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

(g) *Examples*. The following examples illustrate the provisions of paragraph (f) of this section. For purposes of these examples, assume that the Specified Cooperative has satisfied the applicable written notice requirements in paragraphs (c)(3), (d)(3) and (f)(3) of this section.

(1) *Example 1. Patron of Specified Cooperative with W–2 wages*. (i) P, a grain farmer and patron of nonexempt Specified Cooperative C, delivered to C during 2020 2% of all grain marketed through C during such year. During 2021, P receives $20,000 in patronage dividends and $1,000 of allocated section 199A(g) deduction from C related to the grain delivered to C during 2020.

(ii) P has taxable income of $75,000 for 2021 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business for 2021 is $50,000, which consists of gross receipts of $150,000 from sales to an independent grain elevator, per-unit retain allocations received from C during 2021 of $80,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $20,000, and expenses of $200,000 (including $50,000 of W–2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2021 is $10,000, which consists of per-unit retain allocations received from C during 2021 of $80,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $20,000, and properly allocable expenses of $90,000 (including $25,000 of W–2 wages).

(iv) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W–2 wages related to qualified payments received from C ($12,500), or $9,100. As P does not have any other trades or businesses, the combined QBI amount is also $9,100.

(v) P's deduction under section 199A for 2021 is $10,100, which consists of the combined QBI amount of $9,100, plus P's deduction passed through from C of $1,000.

(2) *Example 2. Patron of Specified Cooperative without W–2 wages.* (i) C and P have the same facts for 2020 and 2021 as *Example 1,* except that P has expenses of $200,000 that include zero W–2 wages during 2021.

(ii) P's deductible amount related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($900) or 50% of W–2 wages related to qualified payments received from C ($0), or $10,000.

(iii) P's deduction under section 199A for 2021 is $11,000, which consists of the combined QBI amount of $10,000, plus P's deduction passed through from C of $1,000.

(3) *Example 3. Patron of Specified Cooperative—Qualified Payments do not equal QBI and no section 199A(g) passthrough.* (i) P, a grain farmer and a patron of a nonexempt Specified Cooperative C, during 2020, receives $60,000 in patronage dividends, $100,000 in per-unit retain allocations, and $0 of allocated section 199A(g) deduction from C related to the grain delivered to C. C notifies P that only $150,000 of the patronage dividends and per-unit retain allocations are qualified payments because $10,000 of the payments are not attributable to C's QPAI.

(ii) P has taxable income of $90,000 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to its grain trade or business is $45,000, which consists of gross receipts of $95,000 from sales to an independent grain elevator, plus $160,000 from C (all payments from C qualify as qualified items of income, gain, deduction, and loss), less expenses of $210,000 (including $30,000 of W–2 wages).

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C is $25,000, which consists of the qualified payments received from C of $150,000, less the properly allocable expenses of $125,000 (including $18,000 of W–2 wages), which were determined using a reasonable method under paragraph (f)(2)(ii) of this section.

(iv) P's patron reduction is $2,250, which is the lesser of 9% of QBI related to qualified payments received from C, $2,250 (9% × $25,000), or 50% of W–2 wages related to qualified payments received from C, $9,000 (50% × $18,000). As P does not have any other trades or businesses, the combined QBI amount is $6,750 (20% of P's total QBI, $9,000 (20% × $45,000), reduced by the patron reduction of $2,250).

(v) P's deduction under section 199A is $6,750, which consists of the combined QBI amount of $6,750.

(4) *Example 4. Patron of Specified Cooperative—Reasonable Method under paragraph (f)(2)(i) of this section.* P is a grain farmer that has $45,000 of QBI related to P's grain trade or business in 2020. P's QBI consists of $105,000 of sales to an independent grain elevator, $100,000 of per-unit retain allocations, and $50,000 of patronage dividends from a nonexempt Specified Cooperative C, for which C reports $150,000 of qualified payments to P as required by paragraph (f)(3) of this section. P's grain trade or business has $210,000 of expenses (including $30,000 of W–2 wages). P delivered 65x bushels of grain to C

and sold 35x bushels of comparable grain to the independent grain elevator. To allocate the expenses between qualified payments ($150,000) and other income ($105,000), P compares the bushels of grain delivered to C (65x) to the total bushels of grain delivered to C and sold to the independent grain elevator (100x). P determines $136,500 (65% × $210,000) of expenses (including $19,500 of W–2 wages) are properly allocable to the qualified payments. The portion of QBI from P's grain trade or business related to qualified payments received from C is $13,500, which consists of qualified payments of $150,000 less the properly allocable expenses of $136,500 (including $19,500 of W–2 wages). P's method of allocating expenses is a reasonable method under paragraph (f)(2)(i) of this section.

(5) *Example 5. Patron of Specified Cooperative using safe harbor to allocate.* (i) P is a grain farmer with taxable income of $100,000 for 2021 (determined without regard to section 199A) and has a filing status of married filing jointly. P's QBI related to P's grain trade or business for 2021 is $50,000, which consists of gross receipts of $180,000 from sales to an independent grain elevator, per-unit retain allocations received from a Specified Cooperative C during 2021 of $15,000, patronage dividends received from C during 2021 related to C's 2020 net earnings of $5,000, and expenses of $150,000 (including $50,000 of W–2 wages). C also passed through $1,800 of the section 199A(g) deduction to P, which related to the grain delivered by P to the Specified Cooperative during 2020. P uses the safe harbor in paragraph (f)(2)(ii) of this section to determine the expenses (including W–2 wages) allocable to the qualified payments.

(ii) Using the safe harbor to allocate P's $150,000 of expenses, P allocates $15,000 of the expenses to the qualified payments ($150,000 of expenses multiplied by the ratio (0.10) of qualified payments ($20,000) to total gross receipts ($200,000)). Using the same ratio, P also determines there are $5,000 of W–2 wages allocable ($50,000 multiplied by 0.10) to the qualified payments.

(iii) The portion of QBI from P's grain trade or business related to qualified payments received from C during 2021 is $5,000, which consists of per-unit retain allocations received from C during 2021 of $15,000, patronage dividends of $5,000, and properly allocable expenses of $15,000 (including $5,000 of W–2 wages).

(iv) P's QBI related to the grain trade or business is 20% of QBI ($10,000) reduced by the lesser of 9% of QBI related to qualified payments received from C ($450) or 50% of W–2 wages related to qualified payments received from C ($2,500), or $9,550. As P does not have any other trades or businesses, the combined QBI amount is also $9,550.

(v) P's deduction under section 199A for 2021 is $11,350, which consists of the combined QBI amount of $9,550, plus P's deduction passed through from C of $1,800.

(h) *Applicability date*—(1) *General rule.* Except as provided in paragraph (h)(2) of this section, the provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided taxpayers apply the rules in their entirety and in a consistent manner.

(2) *Transition rule for qualified payments of patrons of Cooperatives.* See the transition rule for qualified payments of patrons of Cooperatives for a taxable year of a Cooperative beginning before January 1, 2018 in the Consolidated Appropriations Act, 2018 (Pub. L. 115–141, 132 Stat. 348) Division T, section 101(c).

(3) *Notice from the Cooperative.* If a patron of a Cooperative cannot claim a deduction under section 199A for any qualified payments described in the transition rule set forth in paragraph (h)(2) of this section, the Cooperative must use a reasonable method to identify the qualified payments to its patrons. A reasonable method includes reporting this information on an attachment to or on the Form 1099–PATR (or any successor form) issued by the Cooperative to the patron, unless otherwise provided by the instructions to the Form.

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§ 1.199A–8 Deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives.

(a) *Overview*—(1) *In general.* This section provides rules relating to the deduction for income attributable to domestic production activities of a specified agricultural or horticultural cooperative (Specified Cooperative). This paragraph (a) provides an overview and definitions of certain terms. Paragraph (b) of this section provides rules explaining the steps a nonexempt Specified Cooperative performs to calculate its section 199A(g) deduction and includes definitions of relevant terms. Paragraph (c) of this section provides rules explaining the steps an exempt Specified Cooperative performs to calculate its section 199A(g) deduction. Paragraph (d) of this section provides rules for Specified Cooperatives passing through the section 199A(g) deduction to patrons. Paragraph (e) of this section provides examples that illustrate the provisions of paragraphs (b), (c), and (d) of this section. Paragraph (f) of this section provides guidance for Specified Cooperatives that are partners in a partnership. Paragraph (g) of this section provides guidance on the recapture of a claimed section 199A(g) deduction. Paragraph (h) of this section provides effective dates. For additional rules addressing an expanded affiliated group (EAG), to which the principles of this section apply, *see* §1.199A–12. The provisions of this section apply solely for purposes of section 199A of the Internal Revenue Code (Code).

(2) *Specified Cooperative*—(i) *In general.* Specified Cooperative means a cooperative to which Part I of subchapter T of chapter 1 of the Code applies and which—

(A) Manufactures, produces, grows, or extracts (MPGE) in whole or significant part within the United States any agricultural or horticultural product, or

(B) Is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the United States by the patrons of the cooperative.

(C) See §1.199A–9 for rules to determine if a Specified Cooperative has MPGE an agricultural or horticultural product in whole or significant part within the United States.

(ii) *Types of Specified Cooperatives.* A Specified Cooperative that is qualified as a farmer's cooperative organization under section 521 is an *exempt Specified Cooperative*, while a Specified Cooperative not so qualified is a *nonexempt Specified Cooperative*.

(3) *Patron* is defined in §1.1388–1(e).

(4) *Agricultural or horticultural products* are agricultural, horticultural, viticultural, and dairy products, livestock and the products thereof, the products of poultry and bee raising, the edible products of forestry, and any and all products raised or produced on farms and processed or manufactured products thereof within the meaning of the Cooperative Marketing Act of 1926, 44 Stat. 802 (1926). Agricultural or horticultural products also include aquatic products that are farmed. Some examples of agricultural or horticultural products include, but are not limited to, fruits, grains, oilseeds, rice, vegetables, legumes, grasses (including hay), plants of all kinds, flowers (including hops), seeds, tobacco, cotton, sugar cane and sugar beets. Some examples of livestock products include, but are not limited to, wool, fur, hides, eggs, down, honey, and silk. Some examples of edible forestry products include, but are not limited to, fruits, nuts, berries and mushrooms. Some examples of aquatic products include, but are not limited to, fish, crustaceans, shellfish and seaweed. In addition, agricultural or horticultural products include fertilizer, diesel fuel, and other supplies (for example, seed, feed, herbicides, and pesticides) used in agricultural or horticultural production that are MPGE by a Specified Cooperative. Agricultural or horticultural products, however, do not include intangible property other than when incorporated into a tangible agricultural or horticultural product (other than as provided in the exception in §1.199A–9(b)(2)). Intangible property for this purpose includes, for example, the rights to MPGE and sell an agricultural or horticultural product with certain characteristics protected by a patent, or the rights to a trademark or tradename. This exclusion of intangible property does not apply to intangible characteristics of

any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would be considered from the disposition of agricultural or horticultural products. However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product.

(b) *Steps for a nonexempt Specified Cooperative in calculating deduction*—(1) *In general.* Except as provided in paragraph (c)(3) of this section, this paragraph (b) applies only to nonexempt Specified Cooperatives.

(2) *Step 1—Gross receipts and related deductions*—(i) *Identify.* To determine the section 199A(g) deduction, a Specified Cooperative first identifies its patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W–2 wages, etc. (deductions) and allocates them between patronage and nonpatronage. A single definition for the term *patronage and nonpatronage* is found in §1.1388–1(f).

(ii) *Applicable gross receipts and deductions.* Except as described in this paragraph (b)(ii), for all purposes of the section 199A(g) deduction, a Specified Cooperative can use only patronage gross receipts and related deductions to calculate qualified production activities income (QPAI) as defined in paragraph (b)(4)(ii) of this section, oil-related QPAI as defined in paragraph (b)(7)(ii) of this section, the W–2 wage limitation in paragraph (b)(5)(ii)(B) of this section, or taxable income as defined in paragraph (b)(5)(ii)(C) of this section. A Specified Cooperative cannot use its nonpatronage gross receipts and related deductions to calculate its section 199A(g) deduction, other than treating all of its nonpatronage gross receipts as patronage non-DPGR for purposes of applying the de minimis rules in §1.199A–9(c)(3). If a Specified Cooperative treats all nonpatronage gross receipts as DPGR under §1.199A–9(c)(3)(i), then a Specified Cooperative shall also treat its deductions related to the nonpatronage gross receipts as patronage in calculating QPAI, oil-related QPAI, the W–2 wage limitation, or taxable income for purposes of the section 199A(g) deduction.

(iii) *Gross receipts* are the Specified Cooperative's receipts for the taxable year that are recognized under the Specified Cooperative's methods of accounting used for Federal income tax purposes for the taxable year. See §1.199A–12 if the gross receipts are recognized in an intercompany transaction within the meaning of §1.1502–13. Gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (except interest under section 103 but including original issue discount), dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the Specified Cooperative's trade or business. Gross receipts are not reduced by COGS or by the cost of property sold if such property is described in section 1221(a)(1), (2), (3), (4), or (5). Finally, gross receipts do not include amounts received by the Specified Cooperative with respect to sales tax or other similar state or local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the Specified Cooperative merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the Specified Cooperative under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(3) *Step 2—Determine gross receipts that are DPGR*—(i) *In general.* A Specified Cooperative examines its patronage gross receipts to determine which of these are DPGR. A Specified Cooperative does not use nonpatronage gross receipts to determine DPGR.

(ii) *DPGR* are the gross receipts of the Specified Cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is MPGE by the Specified Cooperative or its patrons in whole or significant part within the United States. DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. See § 1.199A–9 for additional rules on determining if gross receipts are DPGR.

(4) *Step 3—Determine QPAI*—(i) *In general.* A Specified Cooperative determines QPAI from patronage DPGR and patronage deductions identified in paragraphs (b)(3)(ii) and (b)(2)(i) of this section, respectively. A Specified Cooperative does not use nonpatronage gross receipts or deductions to determine QPAI.

(ii) *QPAI* for the taxable year means an amount equal to the excess (if any) of—

(A) DPGR for the taxable year, over

(B) The sum of—

(*1*) COGS that are allocable to DPGR, and

(*2*) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR.

(C) *QPAI computational rules.* QPAI is computed without taking into account the section 199A(g) deduction or any deduction allowed under section 1382(b). *See* § 1.199A–10 for additional rules on calculating QPAI.

(5) *Step 4—Calculate deduction*—(i) *In general.* From QPAI and taxable income, a Specified Cooperative calculates its section 199A(g) deduction as provided in paragraph (b)(5)(ii) of this section.

(ii) *Deduction*—(A) *In general.* A Specified Cooperative is allowed a deduction equal to 9 percent of the lesser of—

(*1*) QPAI of the Specified Cooperative for the taxable year, or

(*2*) Taxable income of the Specified Cooperative for the taxable year.

(B) *W–2 wage limitation.* The deduction allowed under paragraph (b)(5)(ii)(A) of this section for any taxable year cannot exceed 50 percent of the patronage W–2 wages attributable to DPGR for the taxable year. *See* § 1.199A–11 for additional rules on calculating the patronage W–2 wage limitation.

(C) *Taxable income.* Taxable income is defined in section 63, and adjusted under section 1382 and § 1.1382–1 and § 1.1382–2. For purposes of determining the amount of the deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from patronage sources, other than as allowed under paragraph (b)(2)(ii) of this section. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(b). Patronage net operating losses (NOLs) reduce taxable income in the amount that the Specified Cooperative would use to reduce taxable income (no lower than zero) before using the section 199A(g) deduction, but do not reduce taxable income that is the result of not taking into account any deduction allowable under section 1382(b).

(6) *Use of patronage section 199A(g) deduction.* Except as provided in § 1.199A–12(c)(2) related to the rules for EAGs, the patronage section 199A(g) deduction cannot create or increase a patronage or nonpatronage NOL or the amount of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A patronage section 199A(g) deduction can be applied only against patronage income and deductions. A patronage section 199A(g) deduction that is not used in the appropriate taxable year is lost. To the extent that a Specified Cooperative passes through the section 199A(g) deduction to patrons and appropriately adjusts the section 1382 deduction under § 1.199A–8(d), the amount passed through is not considered to create or increase a patronage or nonpatronage NOL or the amount of a patronage or nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172.

(7) *Special rules for nonexempt Specified Cooperatives that have oil-related QPAI*—(i) *Reduction of section 199A(g) deduction.* If a Specified Cooperative has oil-related QPAI for any taxable year, the amount otherwise allowable as a deduction under paragraph (b)(5)(ii) of this section must be reduced by 3 percent of the least of—

(A) Oil-related QPAI of the Specified Cooperative for the taxable year,

(B) QPAI of the Specified Cooperative for the taxable year, or

(C) Taxable income of the Specified Cooperative for the taxable year.

(ii) *Oil-related QPAI* means, for any taxable year, the patronage QPAI that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (within the meaning of section 927(a)(2)(C), as in effect before its repeal) during such taxable year. Oil-related QPAI for any taxable year is an amount equal to the excess (if any) of patronage DPGR derived from the production, refining or processing of oil, gas, or any primary product thereof (oil-related DPGR) over the sum of—

(A) COGS of the Specified Cooperative that is allocable to such receipts; and

(B) Other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to such receipts.

(iii) *Special rule for patronage oil-related DPGR.* Oil-related DPGR does not include gross receipts derived from the transportation or distribution of oil, gas, or any primary product thereof. However, to the extent that the non-exempt Specified Cooperative treats gross receipts derived from transportation or distribution of oil, gas, or any primary product thereof as part of DPGR under §1.199A–9(c)(3)(i), or under §1.199A–9(j)(3)(i)(B), then the Specified Cooperative must treat those patronage gross receipts as oil-related DGPR.

(iv) *Oil* includes oil recovered from both conventional and non-conventional recovery methods, including crude oil, shale oil, and oil recovered from tar/oil sands. The *primary product from oil* includes all products derived from the destructive distillation of oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. The *primary product from gas* means all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. The primary products from oil and gas provided in this paragraph (b)(7)(iv) are not intended to represent either the only primary products from oil or gas, or the only processes from which primary products may be derived under existing and future technologies. Examples of non-primary products include, but are not limited to, petrochemicals, medicinal products, insecticides, and alcohols.

(c) *Exempt Specified Cooperatives*—(1) *In general.* This paragraph (c) applies only to exempt Specified Cooperatives.

(2) *Two section 199A(g) deductions.* The Specified Cooperative must calculate two separate section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced, unless a Specified Cooperative treats all of its nonpatronage gross receipts and related deductions as patronage as described in paragraph (b)(2)(ii) of this section. Patronage and nonpatronage gross receipts, related COGS that are allocable to DPGR, and other expenses, losses, or deductions (other than the section 199A(g) deduction) that are properly allocable to DPGR (deductions), DPGR, QPAI, NOLs, W–2 wages, etc. are not netted to calculate these two separate section 199A(g) deductions.

(3) *Exempt Specified Cooperative patronage section 199A(g) deduction.* The Specified Cooperative calculates its patronage section 199A(g) deduction following steps 1 through 4 in paragraphs (b)(2) through (5) of this section as if it were a nonexempt Specified Cooperative.

(4) *Exempt Specified Cooperative nonpatronage section 199A(g) deduction*—(i) *In general.* The Specified Cooperative calculates its nonpatronage section 199A(g) deduction following steps 2 through 4 in paragraphs (b)(2) through (5) of this section using only nonpatronage gross receipts and related nonpatronage deductions, unless a Specified Cooperative treats all of its nonpatronage gross receipts and related deductions as patronage as described in paragraph (b)(2)(ii) of this section. For purposes of determining the amount of the nonpatronage section 199A(g) deduction allowed under paragraph (b)(5)(ii) of this section, taxable income is limited to taxable income and related deductions from nonpatronage sources. Nonpatronage NOLs reduce taxable income. Taxable income

is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(c).

(ii) *Use of nonpatronage section 199A(g) deduction.* Except as provided in §1.199A–12(c)(2) related to the rules for EAGs, the nonpatronage section 199A(g) deduction cannot create or increase a nonpatronage NOL or the amount of nonpatronage NOL carryover or carryback, if applicable, in accordance with section 172. A Specified Cooperative cannot pass through its nonpatronage section 199A(g) deduction under paragraph (d) of this section and can apply the nonpatronage section 199A(g) deduction only against its nonpatronage income and deductions. As is the case for the patronage section 199A(g) deduction, the nonpatronage section 199A(g) deduction that a Specified Cooperative does not use in the appropriate taxable year is lost.

(d) *Discretion to pass through deduction*—(1) *Permitted amount* (i) *In general.* A Specified Cooperative may, at its discretion, pass through all, some, or none of its patronage section 199A(g) deduction to all patrons. Only eligible taxpayers as defined in section 199A(g)(2)(D) may claim the section 199A(g) deduction that is passed through. A Specified Cooperative member of a federated cooperative may pass through the patronage section 199A(g) deduction it receives from the federated cooperative to its member patrons.

(ii) *Specified Cooperative identifies eligibility of patron.* If a Specified Cooperative determines that a patron is not an eligible taxpayer, then the Specified Cooperative may, at its discretion, retain any of the patronage section 199A(g) deduction attributable to the patron that would otherwise be passed through and lost under the general rule in paragraph (d)(1)(i) of this section.

(2) *Amount of deduction being passed through*—(i) *In general.* A Specified Cooperative is permitted to pass through an amount equal to the portion of the Specified Cooperative's section 199A(g) deduction that is allowed with respect to the portion of the cooperative's QPAI that is attributable to the qualified payments the Specified Cooperative distributed to the patron during the taxable year and identified on the notice required in §1.199A–7(f)(3) on an attachment to or on the Form 1099–PATR, Taxable Distributions Received From Cooperatives (Form 1099–PATR), (or any successor form) issued by the Specified Cooperative to the patron, unless otherwise provided by the instructions to the Form 1099–PATR. The notice requirement to pass through the section 199A(g) deduction is in paragraph (d)(3) of this section.

(ii) *Qualified payment* means any amount of a patronage dividend or per-unit retain allocation, as described in section 1385(a)(1) or (3) received by a patron from a Specified Cooperative that is attributable to the portion of the Specified Cooperative's QPAI, for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the taxable year.

(3) *Notice requirement to pass through deduction.* A Specified Cooperative must identify in a written notice the amount of the section 199A(g) deduction being passed through to its patrons. This written notice must be mailed by the Specified Cooperative to the patron no later than the 15th day of the ninth month following the close of the taxable year of the Specified Cooperative. The Specified Cooperative may use the same written notice, if any, that it uses to notify the patron of the patron's respective allocations of patronage distributions, or may use a separate timely written notice(s) to comply with this section. The Specified Cooperative must report the amount of section 199A(g) deduction passed through to the patron on an attachment to or on the Form 1099–PATR (or any successor form) issued by the Specified Cooperative to the patron, unless otherwise provided by the instructions to the Form 1099–PATR.

(4) *Section 199A(g) deduction allocated to eligible taxpayer.* An eligible taxpayer may deduct the lesser of the section 199A(g) deduction identified on the notice described in paragraph (d)(3) of this section or the eligible taxpayer's taxable income in the taxable year in which the eligible taxpayer receives

the timely written notice described in paragraph (d)(3) of this section. For this purpose, the eligible taxpayer's taxable income is determined without taking into account the section 199A(g) deduction being passed through to the eligible taxpayer and after taking into account any section 199A(a) deduction allowed to the eligible taxpayer. Any section 199A(g) deduction the eligible taxpayer does not use in the taxable year in which the eligible taxpayer receives the notice (received on or before the due date of the Form 1099–PATR) is lost and cannot be carried forward or back to other taxable years. The taxable income limitation for the section 199A(a) deduction set forth in section 199A(b)(3) and § 1.199A–1(a) and (b) does not apply to limit the deductibility of the section 199A(g) deduction passed through to the eligible taxpayer.

(5) *Special rules for eligible taxpayers that are Specified Cooperatives.* Any Specified Cooperative that receives a section 199A(g) deduction as an eligible taxpayer can take the deduction against patronage gross income and related deductions to the extent it relates to its patronage gross income and related deductions. Only a patron that is an exempt Specified Cooperative may take a section 199A(g) deduction passed through from another Specified Cooperative if the deduction relates to the patron Specified Cooperative's nonpatronage gross income and related deductions.

(6) *W–2 wage limitation.* The W–2 wage limitation described in paragraph (b)(5)(ii)(B) of this section is applied at the cooperative level whether or not the Specified Cooperative chooses to pass through some or all of the section 199A(g) deduction. Any section 199A(g) deduction that has been passed through by a Specified Cooperative to an eligible taxpayer is not subject to the W–2 wage limitation a second time at the eligible taxpayer's level.

(7) *Specified Cooperative denied section 1382 deduction for portion of qualified payments.* A Specified Cooperative must reduce its section 1382 deduction by an amount equal to the portion of any qualified payment that is attributable to the Specified Cooperative's section 199A(g) deduction passed through. This means the Specified Cooperative must reduce its section 1382 deduction in an amount equal to the section 199A(g) deduction passed through.

(8) *No double counting.* A qualified payment received by a Specified Cooperative that is a patron of a Specified Cooperative is not taken into account by the patron for purposes of section 199A(g).

(e) *Examples.* The following examples illustrate the application of paragraphs (a), (b), (c), and (d) of this section. The examples of this section apply solely for purposes of section 199A of the Code. Assume for each example that the Specified Cooperative sent all required notices to patrons on or before the due date of the Form 1099–PATR.

(1) *Example 1. Nonexempt Specified Cooperative calculating section 199A(g) deduction.* (i) C is a grain marketing nonexempt Specified Cooperative, with $5,250,000 in gross receipts during 2020 from the sale of grain grown by its patrons. C paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations and another $1,000,000 in patronage dividends after the close of the 2020 taxable year. C has other expenses of $250,000 during 2020, including $100,000 of W–2 wages.

(ii) C has DPGR of $5,250,000 and QPAI as defined in § 1.199A–8(b)(4)(ii) of $5,000,000 for 2020. C's section 199A(g) deduction is equal to the least of 9% of QPAI ($450,000), 9% of taxable income ($450,000), or 50% of W–2 wages ($50,000). C passes through the entire section 199A(g) deduction to its patrons. Accordingly, C reduces its $5,000,000 deduction allowable under section 1382(b) (relating to the $1,000,000 patronage dividends and $4,000,000 per-unit retain allocations) by $50,000.

(2) *Example 2. Nonexempt Specified Cooperative determines amounts included in QPAI and taxable income.* (i) C, a nonexempt Specified Cooperative, offers harvesting services and markets the grain of patrons and nonpatrons. C had gross receipts from harvesting services and grain sales, and expenses related to both. All of C's harvesting services were performed for their patrons, and 75% of the grain sales were for patrons.

(ii) C identifies 75% of the gross receipts and related expenses from grain sales and 100% of the gross receipts and related expenses from the harvesting services as patronage sourced. C identifies 25% of the gross receipts and related expenses from grain sales as nonpatronage sourced.

(iii) C does not include any nonpatronage gross receipts or related expenses from grain sales in either QPAI or taxable income when calculating the section 199A(g) deduction. C's QPAI includes the patronage DPGR, less related expenses (allocable COGS, wages and other expenses). C's taxable income includes the patronage gross receipts, whether such gross receipts are DPGR or non-DPGR.

(iv) C allocates and reports patronage dividends to its harvesting patrons and grain marketing patrons. C also notifies its grain marketing patrons (in accordance with the requirements of § 1.199A–7(f)(3)) that their patronage dividends are qualified payments used in C's section 199A(g) computation. The patrons must use this information for purposes of computing their section 199A(b)(7) reduction to their section 199A(a) deduction (*see* § 1.199A–7(f)).

(3) *Example 3. Nonexempt Specified Cooperative with patronage and nonpatronage gross receipts and related deductions.* (i) C, a nonexempt Specified Cooperative, markets corn grown by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. Such gross receipts qualify as DPGR. Assume C has $800 of expenses (including COGS, other expenses, and $400 of W–2 wages) properly allocable to DPGR, and a $1,000 deduction allowed under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500, and has nonpatronage deductions in the amount of $400 (including COGS, other expenses, and $100 of W–2 wages).

(ii) C does not include any gross receipts or deductions from nonpatronage sources when calculating the deduction under paragraph (b)(5)(ii) of this section. C's QPAI and taxable income both equal $1,000 ($1,800 − 800). C's deduction under paragraph (b)(5)(ii) of this section for the taxable year is equal to $90 (9% of $1,000), which does not exceed $200 (50% of C's W–2 wages properly allocable to DPGR).C passes through $90 of the deduction to patrons and C reduces its section 1382(b) deduction by $90.

(4) *Example 4. Exempt Specified Cooperative with patronage and nonpatronage income and deductions.* (i) C, an exempt Specified Cooperative, markets corn MPGE by its patrons in the United States. For the calendar year ending December 31, 2020, C derives gross receipts from the marketing activity of $1,800. For this activity assume C has $800 of expenses (including COGS, other expenses, and $400 of W–2 wages) properly allocable to DPGR, and a $1,000 deduction under section 1382(b). C also derives gross receipts from nonpatronage sources in the amount of $500. Assume the gross receipts qualify as DPGR. For this activity assume C has $400 of expenses (including COGS, other expenses, and $20 of W–2 wages) properly allocable to DPGR and no deduction under section 1382(c).

(ii) C calculates two separate section 199A(g) deduction amounts. C's section 199A(g) deduction attributable to patronage sources is the same as the deduction calculated by the nonexempt Specified Cooperative in *Example 3* in paragraph (e)(3) of this section.

(iii) C's nonpatronage QPAI and taxable income is equal to $100 ($500 − $400). C's deduction under paragraph (c)(4) of this section that directs C to use paragraph (b)(5)(ii) of this section attributable to nonpatronage sources is equal to $9 (9% of $100), which does not exceed $10 (50% of C's W–2 wages properly allocable to DPGR). C cannot pass through any of the nonpatronage section 199A(g) deduction amount to its patrons.

(5) *Example 5. NOL.* (i) In 2021, E, a nonexempt Specified Cooperative that is not part of an EAG, generates QPAI and taxable income of $100 (without taking into account any section 1382(b) deductions, NOLs, or the section 199A(g) deduction). E pays out patronage dividends of $91 that are deductible under section 1382(b). E has an NOL carryover of $500 attributable to losses incurred prior to 2018. While taxable income and QPAI do not take into account the section 1382(b) deduction, taxable income does take into account NOLs. When calculating its section

199A(g) deduction, E must take into account the NOL carryover when calculating taxable income, unless the taxable income is the result of not taking into account any deduction allowable under section 1382(b). In this case $91 of taxable income is the result of not taking into account the deduction allowed under section 1382(b) and the remaining $9 should be reduced by the NOL carryover so that taxable income equals $91. E calculates a section 199A(g) deduction of $8.19 (.09 × $91 (which is the lesser of $100 QPAI or $91 taxable income)).

(ii) E may pass through the entire $8.19 of section 199A(g) deduction to patrons (which will reduce its section 1382(b) deduction from $91 to $82.81). However, if E does not pass the deduction through, paragraph (b)(6) of this section prohibits E from claiming any of the section 199A(g) deduction in 2021.

(iii) If E passes through the deduction to patrons, E's taxable income under section 172(b)(2) for NOL absorption purposes is $9 ($100 − $82.81 − $9 NOL − $8.19 section 199A(g) deduction). If E does not pass through the deduction, then E's taxable income under section 172(b)(2) for NOL absorption purposes is $9 ($100 − $91 − $9 NOL).

(iv) Assuming E passes through the deduction to patrons, E would use $9 of the NOL carryover and have a $491 NOL carryover remaining. To the extent E does not pass through the deduction, E would still use $9 of the NOL carryover and have a $491 NOL carryover remaining.

(6) *Example 6. Nonexempt Specified Cooperative not passing through the section 199A(g) deduction to patrons.* (i) D, a nonexempt Specified Cooperative, markets corn grown by its patrons within the United States. For its calendar year ended December 31, 2020, D has gross receipts of $1,500,000, all derived from the sale of corn grown by its patrons within the United States. D pays $300,000 for its patrons' corn at the time the grain was delivered in the form of per-unit retain allocations and its W–2 wages (as defined in § 1.199A–11) for 2020 total $300,000. D has no other costs. Patron A is a patron of D. Patron A is a cash basis taxpayer and files Federal income tax returns on a calendar year basis. All corn grown by Patron A in 2020 is sold through D and Patron A is eligible to share in patronage dividends paid by D for that year.

(ii) All of D's gross receipts from the sale of its patrons' corn qualify as DPGR (as defined paragraph (8)(b)(3)(ii) of this section). D's QPAI and taxable income is $1,200,000. D's section 199A(g) deduction for its taxable year 2020 is $108,000 (.09 × $1,200,000). Because this amount is less than 50% of D's W–2 wages, the entire amount is allowed as a section 199A(g) deduction.D decides not to pass any of its section 199A(g) deduction to its patrons. The section 199A(g) deduction of $108,000 is applied to, and reduces, D's taxable income.

(7) *Example 7. Nonexempt Specified Cooperative passing through the section 199A(g) deduction to patrons paid a patronage dividend.* (i) The facts are the same as in Example 6 except that D decides to pass its entire section 199A(g) deduction through to its patrons. D declares a patronage dividend for its 2020 taxable year of $900,000, which it pays on March 15, 2021.Pursuant to paragraph (d)(3) of this section, D notifies patrons in written notices that accompany the patronage dividend notification that D is allocating to them the section 199A(g) deduction D is entitled to claim in the calendar year 2020.On March 15, 2021, Patron A receives a $9,000 patronage dividend that is a qualified payment under paragraph (d)(2)(ii) of this section from D. In the notice that accompanies the patronage dividend, Patron A is designated a $1,080 section 199A(g) deduction. Under paragraph (a) of this section, Patron A may claim a $1,080 section 199A(g) deduction for the taxable year ending December 31, 2021, subject to the limitations set forth under paragraph (d)(4) of this section.

(ii) Under paragraph (d)(7) of this section, D is required to reduce its section 1382 deduction of $1,200,000 by the $108,000 section 199A(g) deduction passed through to patrons (whether D pays patronage dividends on book or Federal income tax net earnings). As a consequence, D is entitled to a section 1382 deduction for the taxable year ending December 31, 2020, in the amount of $1,092,000 ($1,200,000 − $108,000) and to a section 199A(g) deduction in the amount of $108,000 ($1,200,000 × .09).

(8) *Example 8. Nonexempt Specified Cooperative passing through the section 199A(g) deduction to patrons paid a patronage dividend and advances on expected patronage net earnings.* (i) The facts are the same as in Example 6 except that D paid out $500,000 to its patrons as advances on expected patronage net earnings. In 2020, D pays its patrons a $400,000 ($900,000 − $500,000 already paid) patronage dividend in cash or a combination of cash and qualified written notices of allocation. Under paragraph (d)(7) of this section and section 1382, D is allowed a deduction of $1,092,000 ($1,200,000 − $108,000 section 199A(g) deduction), whether patronage net earnings are distributed on book or Federal income tax net earnings.

(ii) The patrons will have received a gross amount of $1,200,000 in qualified payments under paragraph (d)(2)(ii) of this section from Cooperative D ($300,000 paid as per-unit retain allocations, $500,000 paid during the taxable year as advances, and the additional $400,000 paid as patronage dividends). If D passes through its entire section 199A(g) deduction to its patrons by providing the notice required by paragraph (d)(3) of this section, then the patrons will be allowed a $108,000 section 199A(g) deduction, resulting in a net $1,092,000 taxable distribution from D. Pursuant to paragraph (d)(8) of this section, any of the $1,200,000 received by patrons that are Specified Cooperatives from D is not taken into account for purposes of calculating the patrons' section 199A(g) deduction.Patrons that are not Specified Cooperatives must include those payments in the section 199A(b)(7) reduction when calculating a section 199A(a) deduction as applicable.

(9) *Example 9. Intangible property transaction as part of disposition of agricultural or horticultural products.* F, a Specified Cooperative, markets patrons' oranges by processing the oranges into orange juice, and then bottling and selling the orange juice to customers. F markets the orange juice under its own brand name, but F also licenses from G, an unrelated third party, the rights to use G's brand name on the bottled orange juice. F's gross receipts from the sale of both brands of orange juice qualify as DPGR, assuming all other requirements of this section are met.

(10) *Example 10. Intangible property transaction that is not a disposition of an agricultural or horticultural product.* H, a Specified Cooperative, licenses H's brand name to J, an unrelated third party. J purchases oranges, produces orange juice, and then bottles and sells the orange juice to customers. Gross receipts that H derives from the license of the brand name to J are not DPGR from the disposition of an agricultural or horticultural product.

(11) *Example 11. Allocation rules when Specified Cooperative retains the section 199A(g) deduction attributable to non-eligible taxpayers.* K, a Specified Cooperative, for the taxable year has $200 of taxable income and QPAI ($100 is attributable to business done for patrons that are C corporation patrons and $100 is attributable to business done for patrons that are eligible taxpayers). K calculates an $18 section 199A(g) deduction. K passes through $9 to its patrons that are eligible taxpayers, distributes $191 to patrons in distributions that are deductible under section 1382(b) (including patronage dividends that were paid out in the same amounts to C corporation patrons and eligible taxpayer patrons because the value of their business,$100 each, was the same), and adjusts its deduction under section 1382 by $9 (the amount of the section 199A(g) deduction passed through). K's taxable income after the section 199A deduction and distributions is $0.

(f) *Special rule for Specified Cooperative partners.* In the case described in section 199A(g)(5)(B), where a Specified Cooperative is a partner in a partnership, the partnership must separately identify and report on the Schedule K–1 of the Form 1065, U.S. Return of Partnership Income (or any successor form) issued to the Specified Cooperative partner the cooperative's share of gross receipts and related deductions, W–2 wages, and COGS, unless otherwise provided by the instructions to the Form. The Specified Cooperative partner determines what gross receipts reported by the partnership qualify as DPGR and includes these gross receipts and related deductions, W–2 wages, and COGS to calculate one section 199A(g) deduction (in the case of a nonexempt

Specified Cooperative) or two section 199A(g) deductions (in the case of an exempt Specified Cooperative) using the steps set forth in paragraphs (b) and (c) of this section. For purposes of determining whether gross receipts are DPGR, the MPGE activities of the Specified Cooperative partner may be attributed to the partnership, and the partnership's MPGE activities may be attributed to the Specified Cooperative partner.

(g) *Recapture of section 199A(g) deduction.* If the amount of the section 199A(g) deduction that was passed through to eligible taxpayers exceeds the amount allowable as a section 199A(g) deduction as determined on examination or reported on an amended return, then recapture of the excess will occur at the Specified Cooperative level in the taxable year the Specified Cooperative took the excess section 199A(g) deduction.

(h) *Applicability date.* Except as provided in paragraph (h)(2) of §1.199A–7, the provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

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§ 1.199A–9 Domestic production gross receipts.

(a) *Domestic production gross receipts*—(1) *In general.* The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance to determine what gross receipts (defined in §1.199A–8(b)(2)(iii)) are domestic production gross receipts (DPGR) (defined in §1.199A–8(b)(3)(ii)). DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. Partners, including partners in an EAG partnership described in §1.199A–12(i)(1), may not treat guaranteed payments under section 707(c) as DPGR.

(2) *Application to marketing cooperatives.* For purposes of determining DPGR, a Specified Cooperative (defined in §1.199A–8(a)(2)) will be treated as having manufactured, produced, grown, or extracted (MPGE) (defined in paragraph (f) of this section) in whole or significant part (defined in paragraph (h) of this section) any agricultural or horticultural product (defined in §1.199A–8(a)(4)) within the United States (defined in paragraph (i) of this section) marketed by the Specified Cooperative which its patrons (defined in §1.1388–1(e)) have so MPGE.

(b) *Related persons*—(1) *In general.* Pursuant to section 199A(g)(3)(D)(ii), DPGR does not include any gross receipts derived from agricultural or horticultural products leased, licensed, or rented by the Specified Cooperative for use by any related person. A person is treated as related to another person if both persons are treated as a single employer under either section 52(a) or (b) (without regard to section 1563(b)), or section 414(m) or (o). Any other person is an unrelated person for purposes of the section 199A(g) deduction.

(2) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, gross receipts derived from any agricultural or horticultural product leased or rented by the Specified Cooperative to a related person may qualify as DPGR if the agricultural or horticultural product is held for sublease or rent, or is subleased or rented, by the related person to an unrelated person for the ultimate use of the unrelated person. Similarly, notwithstanding paragraph (b)(1) of this section, gross receipts derived from a license of the right to reproduce an agricultural or horticultural product to a related person for reproduction and sale, exchange, lease, or rental to an unrelated person for the ultimate use of the unrelated person are treated as gross receipts from a disposition of an agricultural or horticultural product and may qualify as DPGR.

(c) *Allocating gross receipts*—(1) *In general.* A Specified Cooperative must determine the portion of its gross receipts for the taxable year that is DPGR and the portion of its gross receipts that is non-DPGR using a reasonable method based on all the facts and circumstances. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition the gross receipts of which may constitute DPGR, whether it is a service the gross receipts of which may constitute non-DPGR, or some combination thereof. For example, if a Specified Cooperative sells an agricultural or horticultural product and, in connection with that sale, also provides services, the Specified Cooperative must allocate its gross receipts from the transaction using a reasonable method based on all the facts and circumstances that accurately identifies the gross receipts that constitute DPGR and non-DPGR in accordance with the requirements of §1.199A–8(b) and/or (c). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts for the taxable year that is DPGR and the portion of gross receipts that is non-DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (c)(1).

(2) *Reasonable method of allocation.* If a Specified Cooperative has the information readily available and can, without undue burden or expense, specifically identify whether the gross receipts are derived from an item (and thus, are DPGR), then the Specified Cooperative must use that specific identification to determine DPGR. If the Specified Cooperative does not have information readily available to specifically identify whether gross receipts are derived from an item or cannot, without undue burden or expense, specifically identify whether gross receipts are derived from an item, then the Specified Cooperative is not required to use a method that specifically identifies whether the gross receipts are derived from an item but can use a reasonable allocation method. Factors taken into consideration in determining whether the Specified Cooperative's method of allocating gross receipts between DPGR and non-DPGR is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the gross receipts and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year.

(3) *De minimis rules*—(i) *DPGR.* A Specified Cooperative's applicable gross receipts as provided in §1.199A–8(b) and/or (c) may be treated as DPGR if less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR (after application of the exceptions provided in §1.199A–9(j)(3)). If the amount of the Specified Cooperative's gross receipts that are non-DPGR equals or exceeds 10 percent of the Specified Cooperative's total gross receipts, then, except as provided in paragraph (c)(3)(ii) of this section, the Specified Cooperative is required to allocate all gross receipts between DPGR and non-DPGR in accordance with paragraph (c)(1) of this section. If a Specified Cooperative is a member of an expanded affiliated group (EAG) (defined in §1.199A–12), but is not a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are non-DPGR is made at the consolidated group level. *See* §1.199A–12(d).

(ii) *Non-DPGR.* A Specified Cooperative's applicable gross receipts as provided in §1.199A–8(b) and/or (c) may be treated as non-DPGR if less than 10 percent of the Specified Cooperative's total gross receipts are DPGR. If a Specified Cooperative is a member of an EAG, but is not a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are DPGR is made at the Specified Cooperative level. If a Specified Cooperative is a member of a consolidated group, then the determination of whether less than 10 percent of the Specified Cooperative's total gross receipts are DPGR is made at the consolidated group level.

(d) *Use of historical data for multiple-year transactions.* If a Specified Cooperative recognizes and reports gross receipts from upfront payments or other similar payments on a Federal income tax return for a taxable year, then the Specified Cooperative's use of historical data in making an allocation of gross receipts from the transaction between DPGR and non-DPGR may constitute a reasonable method. If a Specified Cooperative makes allocations using historical data, and subsequently updates the data, then the Specified Cooperative must use the more recent or updated data, starting in the taxable year in which the update is made.

(e) *Determining DPGR item-by-item*—(1) *In general.* For purposes of the section 199A(g) deduction, a Specified Cooperative determines, using a reasonable method based on all the facts and circumstances, whether gross receipts qualify as DPGR on an item-by-item basis (and not, for example, on a division-by-division, product line-by-product line, or transaction-by-transaction basis). The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of gross receipts that is DPGR. The books and records maintained for gross receipts must be consistent with any allocations under this paragraph (e)(1).

(i) The term *item* means the agricultural or horticultural product offered by the Specified Cooperative in the normal course of its trade or business for lease, rental, license, sale, exchange, or other disposition (for purposes of this paragraph (e), collectively referred to as disposition) to customers, if the gross receipts from the disposition of such product qualify as DPGR; or

(ii) If paragraph (e)(1)(i) of this section does not apply to the product, then any component of the product described in paragraph (e)(1)(i) of this section is treated as the item, provided that the gross receipts from the disposition of the product described in paragraph (e)(1)(i) of this section that are attributable to such component qualify as DPGR. Each component that meets the requirements under this paragraph (e)(1)(ii) must be treated as a separate item and a component that meets the requirements under this paragraph (e)(1)(ii) may not be combined with a component that does not meet these requirements.

(2) *Special rules.* (i) For purposes of paragraph (e)(1)(i) of this section, in no event may a single item consist of two or more products unless those products are offered for disposition, in the normal course of the Specified Cooperative's trade or business, as a single item (regardless of how the products are packaged).

(ii) In the case of agricultural or horticultural products customarily sold by weight or by volume, the item is determined using the most common custom of the industry (for example, barrels of oil).

(3) *Exception.* If the Specified Cooperative MPGE agricultural or horticultural products within the United States that it disposes of, and the Specified Cooperative leases, rents, licenses, purchases, or otherwise acquires property that contains or may contain the agricultural or horticultural products (or a portion thereof), and the Specified Cooperative cannot reasonably determine, without undue burden and expense, whether the acquired property contains any of the original agricultural or horticultural products MPGE by the Specified Cooperative, then the Specified Cooperative is not required to determine whether any portion of the acquired property qualifies as an item for purposes of paragraph (e)(1) of this section. Therefore, the gross receipts derived from the disposition of the acquired property may be treated as non-DPGR. Similarly, the preceding sentences apply if the Specified Cooperative can reasonably determine that the acquired property contains agricultural or horticultural products (or a portion thereof) MPGE by the Specified Cooperative, but cannot reasonably determine, without undue burden or expense, how much, or what type, grade, etc., of the agricultural or horticultural MPGE by the Specified Cooperative the acquired property contains.

(f) *Definition of manufactured, produced, grown, or extracted (MPGE)*—(1) *In general.* Except as provided in paragraphs (f)(2) and (3) of this section, the term *MPGE* includes manufacturing, producing, growing, extracting, installing, developing, improving, and creating agricultural or horticultural products; making agricultural or horticultural products out of material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; cultivating soil, raising livestock, and farming aquatic products. The term MPGE also includes storage, handling, or other processing activities (other than transportation activities) within the United States related to the sale, exchange, or other disposition of agricultural or horticultural products only if the products are consumed in connection with or incorporated into the MPGE of agricultural or horticultural products, whether or not by the Specified Cooperative. The Specified Cooperative (or the patron if §1.199A–9(a)(2) applies) must have the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the MPGE activity occurs for the gross receipts derived from the MPGE of the agricultural or horticultural products to qualify as DPGR.

(2) *Packaging, repackaging, or labeling.* If the Specified Cooperative packages, repackages, or labels agricultural or horticultural products and engages in no other MPGE activity with respect to those agricultural or horticultural products, the packaging, repackaging, or labeling does not qualify as MPGE with respect to those agricultural or horticultural products.

(3) *Installing.* If a Specified Cooperative installs agricultural or horticultural products and engages in no other MPGE activity with respect to the agricultural or horticultural products, the Specified Cooperative's installing activity does not qualify as an MPGE activity. Notwithstanding paragraph (j)(3)(i)(A) of this section, if the Specified Cooperative installs agricultural or horticultural products MPGE by the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under Federal income tax principles during the period the installing activity occurs, then the portion of the installing activity that relates to the agricultural or horticultural products is an MPGE activity.

(4) *Consistency with section 263A.* A Specified Cooperative that has MPGE agricultural or horticultural products for the taxable year must treat itself as a producer under section 263A with respect to the agricultural or horticultural products unless the Specified Cooperative is not subject to section 263A. A Specified Cooperative that currently is not properly accounting for its production activities under section 263A, and wishes to change its method of accounting to comply with the producer requirements of section 263A, must follow the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for further guidance, for example, *see* Rev. Proc. 2015–13, 2015–5 IRB 419, or any applicable subsequent guidance (*see* §601.601(d)(2) of this chapter)).

(5) *Examples.* The following examples illustrate the application of paragraphs (f)(1), (2), and (3) of this section.

(i) *Example 1. MPGE activities conducted within United States.* A, B, and C are unrelated persons. A is a Specified Cooperative, B is an individual patron of A, and C is a C corporation. B grows agricultural products outside of the United States and A markets those agricultural products for B. A stores the agricultural products in agricultural storage bins in the United States and has the benefits and burdens of ownership under Federal income tax principles of the agricultural products while they are being stored. A sells the agricultural products to C, who processes them into refined agricultural products in the United States. The gross receipts from A's activities are DPGR from the MPGE of agricultural products.

(ii) *Example 2. MPGE activities conducted within and outside United States.* The facts are the same as in Example 1 except that B grows the agricultural products outside the United States and

C processes them into refined agricultural products outside the United States. Pursuant to paragraph (f)(1) of this section, the gross receipts derived by A from its sale of the agricultural products to C are DPGR from the MPGE of agricultural products within the United States.

(g) *By the taxpayer.* With respect to the exception of the rules applicable to an EAG and EAG partnerships under §1.199A–12, only one Specified Cooperative may claim the section 199A(g) deduction with respect to any qualifying activity under paragraph (f) of this section performed in connection with the same agricultural or horticultural product. If an unrelated party performs a qualifying activity under paragraph (f) of this section pursuant to a contract with a Specified Cooperative (or its patron as relevant under paragraph (a)(2) of this section), then only if the Specified Cooperative (or its patron) has the benefits and burdens of ownership of the agricultural or horticultural product under Federal income tax principles during the period in which the qualifying activity occurs is the Specified Cooperative (or its patron) treated as engaging in the qualifying activity.

(h) *In whole or significant part defined*—(1) *In general.* Agricultural or horticultural products must be MPGE in whole or significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) and in whole or significant part within the United States to qualify under section 199A(g)(3)(D)(i). If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE agricultural or horticultural products for the Specified Cooperative and the Specified Cooperative has the benefits and burdens of ownership of the agricultural or horticultural products under applicable Federal income tax principles during the period the MPGE activity occurs, then, pursuant to paragraph (g) of this section, the Specified Cooperative is considered to MPGE the agricultural or horticultural products under this section. The unrelated person must perform the MPGE activity on behalf of the Specified Cooperative in whole or significant part within the United States in order for the Specified Cooperative to satisfy the requirements of this paragraph (h)(1).

(2) *Substantial in nature.* Agricultural or horticultural products will be treated as MPGE in whole or in significant part by the Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) within the United States for purposes of paragraph (h)(1) of this section. However, MPGE of the agricultural or horticultural products by the Specified Cooperative within the United States must be substantial in nature taking into account all the facts and circumstances, including the relative value added by, and relative cost of, the Specified Cooperative's MPGE within the United States, the nature of the agricultural or horticultural products, and the nature of the MPGE activity that the Specified Cooperative performs within the United States. The MPGE of a key component of an agricultural or horticultural product does not, in itself, meet the substantial-in-nature requirement with respect to an agricultural or horticultural product under this paragraph (h)(2). In the case of an agricultural or horticultural product, research and experimental activities under section 174 and the creation of intangible assets are not taken into account in determining whether the MPGE of the agricultural or horticultural product is substantial in nature.

(3) *Safe harbor*—(i) *In general.* A Specified Cooperative (or its patrons in the case described in paragraph (a)(2) of this section) will be treated as having MPGE an agricultural or horticultural product in whole or in significant part within the United States for purposes of paragraph (h)(1) of this section if the direct labor and overhead of such Specified Cooperative to MPGE the agricultural or horticultural product within the United States account for 20 percent or more of the Specified Cooperative's COGS of the agricultural or horticultural product, or in a transaction without COGS (for example, a lease, rental, or license), account for 20 percent or more of the Specified Cooperative's unadjusted depreciable basis (as defined in paragraph (h)(3)(ii) of this section) in property included in the

definition of agricultural or horticultural products. For Specified Cooperatives subject to section 263A, overhead is all costs required to be capitalized under section 263A except direct materials and direct labor. For Specified Cooperatives not subject to section 263A, overhead may be computed using a reasonable method based on all the facts and circumstances, but may not include any cost, or amount of any cost, that would not be required to be capitalized under section 263A if the Specified Cooperative were subject to section 263A. Research and experimental expenditures under section 174 and the costs of creating intangible assets are not taken into account in determining direct labor or overhead for any agricultural or horticultural product. In the case of agricultural or horticultural products, research and experimental expenditures under section 174 and any other costs incurred in the creation of intangible assets may be excluded from COGS or unadjusted depreciable basis for purposes of determining whether the Specified Cooperative meets the safe harbor under this paragraph (h)(3). For Specified Cooperatives not subject to section 263A, the chosen reasonable method to compute overhead must be consistently applied from one taxable year to another and must clearly reflect the Specified Cooperative's portion of overhead not subject to section 263A. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for overhead must be consistent with any allocations under this paragraph (h)(3)(i).

(ii) *Unadjusted depreciable basis.* The term unadjusted depreciable basis means the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis does not reflect the reduction in basis for—

(A) Any portion of the basis the Specified Cooperative properly elects to treat as an expense under sections 179 or 179C; or

(B) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)).

(4) *Special rules*—(i) *Contract with an unrelated person.* If a Specified Cooperative enters into a contract with an unrelated person for the unrelated person to MPGE an agricultural or horticultural product within the United States for the Specified Cooperative, and the Specified Cooperative is considered to MPGE the agricultural or horticultural product pursuant to paragraph (f)(1) of this section, then, for purposes of the substantial-in-nature requirement under paragraph (h)(2) of this section and the safe harbor under paragraph (h)(3)(i) of this section, the Specified Cooperative's MPGE activities or direct labor and overhead must include both the Specified Cooperative's MPGE activities or direct labor and overhead to MPGE the agricultural or horticultural product within the United States as well as the MPGE activities or direct labor and overhead of the unrelated person to MPGE the agricultural or horticultural product within the United States under the contract.

(ii) *Aggregation.* In determining whether the substantial-in-nature requirement under paragraph (h)(2) of this section or the safe harbor under paragraph (h)(3)(i) of this section is met at the time the Specified Cooperative disposes of an agricultural or horticultural product—

(A) An EAG member must take into account all the previous MPGE activities or direct labor and overhead of the other members of the EAG;

(B) An EAG partnership as defined in §1.199A–12(i)(1) must take into account all of the previous MPGE activities or direct labor and overhead of all members of the EAG in which the partners of the EAG partnership are members (as well as the previous MPGE activities of any other EAG partnerships owned by members of the same EAG); and

(C) A member of an EAG in which the partners of an EAG partnership are members must take into account all of the previous MPGE activities or direct labor and overhead of the EAG partnership (as well as those of any other members of the EAG and any previous MPGE activities of any other EAG partnerships owned by members of the same EAG).

(i) *United States defined.* For purposes of section 199A(g), the term *United States* includes the 50 states, the District of Columbia, the territorial waters of the United States, and the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Consistent with its definition in section 7701(a)(9), the term *United States* does not include possessions and territories of the United States or the airspace or space over the United States and these areas.

(j) *Derived from the lease, rental, license, sale, exchange, or other disposition*—(1) *In general*—(i) *Definition.* The term *derived from the lease, rental, license, sale, exchange, or other disposition* is defined as, and limited to, the gross receipts directly derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products even if the Specified Cooperative has already recognized receipts from a previous lease, rental, license, sale, exchange, or other disposition of the same agricultural or horticultural products. Applicable Federal income tax principles apply to determine whether a transaction is, in substance, a lease, rental, license, sale, exchange, or other disposition, whether it is a service, or whether it is some combination thereof.

(ii) *Lease income.* The financing and interest components of a lease of agricultural or horticultural products are considered to be derived from the lease of such agricultural or horticultural products. However, any portion of the lease income that is attributable to services or non-qualified property as defined in paragraph (j)(3) of this section is not derived from the lease of agricultural or horticultural products.

(iii) *Income substitutes.* The proceeds from business interruption insurance, governmental subsidies, and governmental payments not to produce are treated as gross receipts derived from the lease, rental, license, sale, exchange, or other disposition to the extent they are substitutes for gross receipts that would qualify as DPGR.

(iv) *Exchange of property*—(A) *Taxable exchanges.* The value of property received by the Specified Cooperative in a taxable exchange of agricultural or horticultural products MPGE in whole or in significant part by the Specified Cooperative within the United States is DPGR for the Specified Cooperative (assuming all the other requirements of this section are met). However, unless the Specified Cooperative meets all of the requirements under this section with respect to any additional MPGE by the Specified Cooperative of the agricultural or horticultural products received in the taxable exchange, any gross receipts derived from the sale by the Specified Cooperative of the property received in the taxable exchange are non-DPGR, because the Specified Cooperative did not MPGE such property, even if the property was an agricultural or horticultural product in the hands of the other party to the transaction.

(B) *Safe harbor.* For purposes of paragraph (j)(1)(iv)(A) of this section, the gross receipts derived by the Specified Cooperative from the sale of eligible property (as defined in paragraph (j)(1)(iv)(C) of this section) received in a taxable exchange, net of any adjustments between the parties involved in the taxable exchange to account for differences in the eligible property exchanged (for example, location differentials and product differentials), may be treated as the value of the eligible property received by the Specified Cooperative in the taxable exchange. For purposes of the preceding sentence, the taxable exchange is deemed to occur on the date of the sale of the eligible property received in the taxable exchange by the Specified Cooperative, to the extent the sale occurs no later than the last day of the month following the month in which the exchanged eligible property is received by the Specified Cooperative. In addition, if the Specified Cooperative engages in any further MPGE activity with respect to the eligible property received in the taxable exchange, then, unless the Specified Cooperative meets the in-whole-or-in-significant-part requirement under paragraph (h)(1) of this section with respect to the property sold, for purposes of this paragraph (j)(1)(iv)(B), the Specified Cooperative must also value the property sold without taking into account the gross receipts attributable to the further MPGE activity.

(C) *Eligible property*. For purposes of paragraph (j)(1)(iv)(B) of this section, eligible property is—

(*1*) Oil, natural gas, or petrochemicals, or products derived from oil, natural gas, or petrochemicals; or

(*2*) Any other property or product designated by publication in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii)(b) of this chapter).

(*3*) For this purpose, the term *natural gas* includes only natural gas extracted from a natural deposit and does not include, for example, methane gas extracted from a landfill. In the case of natural gas, production activities include all activities involved in extracting natural gas from the ground and processing the gas into pipeline quality gas.

(2) *Hedging transactions*—(i) *In general*. For purposes of this section, if a transaction is a hedging transaction within the meaning of section 1221(b)(2)(A) and § 1.1221–2(b), is properly identified as a hedging transaction in accordance with § 1.1221–2(f), and the risk being hedged relates to property described in section 1221(a)(1) that gives rise to DPGR or to property described in section 1221(a)(8) that is consumed in an activity that gives rise to DPGR, then—

(A) In the case of a hedge of purchases of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining COGS;

(B) In the case of a hedge of sales of property described in section 1221(a)(1), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR; and

(C) In the case of a hedge of purchases of property described in section 1221(a)(8), income, deduction, gain, or loss on the hedging transaction must be taken into account in determining DPGR.

(ii) *Allocation*. The income, deduction, gain and loss from hedging transactions described in paragraph (j)(2) of this section must be allocated between the patronage and nonpatronage (defined in § 1.1388–1(f)) sourced income and related deductions of the Specified Cooperatives consistent with the cooperative's method for determining patronage and nonpatronage income and deductions.

(iii) *Effect of identification and non-identification*. The principles of § 1.1221–2(g) apply to a Specified Cooperative that identifies or fails to identify a transaction as a hedging transaction, except that the consequence of identifying as a hedging transaction a transaction that is not in fact a hedging transaction described in paragraph (j)(2) of this section, or of failing to identify a transaction that the Specified Cooperative has no reasonable grounds for treating as other than a hedging transaction described in paragraph (j)(2) of this section, is that deduction or loss (but not income or gain) from the transaction is taken into account under paragraph (j)(2) of this section.

(iv) *Other rules*. See § 1.1221–2(e) for rules applicable to hedging by members of a consolidated group and § 1.446–4 for rules regarding the timing of income, deductions, gains or losses with respect to hedging transactions.

(3) *Allocation of gross receipts to embedded services and non-qualified property*—(i) *Embedded services and non-qualified property*—(A) *In general*. Except as otherwise provided in paragraph (j)(3)(i)(B) of this section, gross receipts derived from the performance of services do not qualify as DPGR. In the case of an embedded service, that is, a service the price of which, in the normal course of the business, is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products, DPGR includes only the gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products (assuming all the other requirements of this section

are met) and not any receipts attributable to the embedded service. In addition, DPGR does not include gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of property that does not meet all of the requirements under this section (non-qualified property). The allocation of the gross receipts attributable to the embedded services or non-qualified property will be deemed to be reasonable if the allocation reflects the fair market value of the embedded services or non-qualified property.

(B) *Exceptions.* There are five exceptions to the rules under paragraph (j)(3)(i)(A) of this section regarding embedded services and non-qualified property. A Specified Cooperative may include in DPGR, if all the other requirements of this section are met with respect to the underlying item of agricultural or horticultural products to which the embedded services or non-qualified property relate, the gross receipts derived from—

(*1*) A qualified warranty, that is, a warranty that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(*i*)The price for the warranty is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(*ii*) The warranty is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the warranty).

2) A qualified delivery, that is, a delivery or distribution service that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(*i*) The price for the delivery or distribution service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(*ii*) The delivery or distribution service is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the delivery or distribution service).

(*3*) A qualified operating manual, that is, a manual of instructions that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(*i*) The price for the manual is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products;

(*ii*) The manual is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the manual); and

(*iii*) The manual is not provided in connection with a training course for customers.

(*4*) A qualified installation, that is, an installation service for agricultural or horticultural products that is provided in connection with the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products if, in the normal course of the Specified Cooperative's business—

(*i*) The price for the installation service is not separately stated from the amount charged for the lease, rental, license, sale, exchange, or other disposition of the agricultural or horticultural products; and

(*ii*) The installation is neither separately offered by the Specified Cooperative nor separately bargained for with customers (that is, a customer cannot purchase the agricultural or horticultural products without the installation service).

(*5*) A *de minimis* amount of gross receipts from embedded services and non-qualified property for each item of agricultural or horticultural products may qualify. For purposes of this exception, a *de minimis* amount of gross receipts from embedded services and non-qualified property is less than 5 percent of the total gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of each item of agricultural or horticultural products. In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this *de minimis* exception is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if a Specified Cooperative treats gross receipts as DPGR under this *de minimis* exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as DPGR. The gross receipts that the Specified Cooperative treats as DPGR under paragraphs (j)(3)(i)(B)(1) through (4) of this section are treated as DPGR for purposes of applying this *de minimis* exception. This *de minimis* exception does not apply if the price of a service or non-qualified property is separately stated by the Specified Cooperative, or if the service or non-qualified property is separately offered or separately bargained for with the customer (that is, the customer can purchase the agricultural or horticultural products without the service or non-qualified property).

(ii) *Non-DPGR*. Applicable gross receipts as provided in §§1.199A–8(b) and/or (c) derived from the lease, rental, license, sale, exchange or other disposition of an item of agricultural or horticultural products may be treated as non-DPGR if less than 5 percent of the Specified Cooperative's total gross receipts derived from the lease, rental, license, sale, exchange or other disposition of that item are DPGR (taking into account embedded services and non-qualified property included in such disposition, but not part of the item). In the case of gross receipts derived from the lease, rental, license, sale, exchange, or other disposition of agricultural or horticultural products that are received over a period of time (for example, a multi-year lease or installment sale), this paragraph (j)(5)(ii) is applied by taking into account the total gross receipts for the entire period derived (and to be derived) from the lease, rental, license, sale, exchange, or other disposition of the item of agricultural or horticultural products. For purposes of the preceding sentence, if the Specified Cooperative treats gross receipts as non-DPGR under this *de minimis* exception, then the Specified Cooperative must treat the gross receipts recognized in each taxable year consistently as non-DPGR.

(k) *Applicability date*. The provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

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§ 1.199A–10 Allocation of cost of goods sold (COGS) and other deductions to domestic production gross receipts (DPGR), and other rules.

(a) *In general*. The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide additional guidance on determining qualified production activities income (QPAI) as described and defined in §1.199A–8(b)(4)(ii).

(b) *COGS allocable to DPGR*—(1) *In general*. When determining its QPAI, the Specified Cooperative (defined in §1.199A–8(a)(2)) must subtract from its DPGR (defined in §1.199A–8(b)(3)(ii)) the COGS allocable to its DPGR. The Specified Cooperative determines its COGS allocable to DPGR in accordance with this paragraph (b)(1) or, if applicable, paragraph (f) of this section. In the case of a sale, exchange, or other disposition of inventory, COGS is equal to beginning inventory of the Specified Cooperative plus purchases and production costs incurred during the taxable year and included in inventory costs by the Specified Cooperative, less ending inventory of the Specified Cooperative. In determining its QPAI, the Specified Cooperative does not include in COGS any payment made, whether during the taxable year, or included in beginning inventory, for which a deduction is allowed under section 1382(b) and/or (c), as applicable. *See* §1.199A–8(b)(4)(ii)(C). COGS is determined under the methods of accounting that the Specified Cooperative uses to compute taxable income. *See* sections 263A, 471, and 472. If section 263A requires the Specified Cooperative to include additional section 263A costs (as defined in §1.263A–1(d)(3)) in inventory, additional section 263A costs must be included in determining COGS. COGS also include the Specified Cooperative's inventory valuation adjustments such as write-downs under the lower of cost or market method. In the case of a sale, exchange, or other disposition (including, for example, theft, casualty, or abandonment) by the Specified Cooperative of non-inventory property, COGS for purposes of this section includes the adjusted basis of the property.

(2) *Allocating COGS*—(i) *In general.* A Specified Cooperative must use a reasonable method based on all the facts and circumstances to allocate COGS between DPGR and non-DPGR. Whether an allocation method is reasonable is based on all the facts and circumstances, including whether the Specified Cooperative uses the most accurate information available; the relationship between COGS and the method used; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the availability of costing information; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. Depending on the facts and circumstances, reasonable methods may include methods based on gross receipts (defined in §1.199A–8(b)(2)(iii)), number of units sold, number of units produced, or total production costs. Ordinarily, if a Specified Cooperative uses a method to allocate gross receipts between DPGR and non-DPGR, then the use of a different method to allocate COGS that is not demonstrably more accurate than the method used to allocate gross receipts will not be considered reasonable. However, if a Specified Cooperative has information readily available to specifically identify COGS allocable to DPGR and can specifically identify that amount without undue burden or expense, COGS allocable to DPGR is that amount irrespective of whether the Specified Cooperative uses another allocation method to allocate gross receipts between DPGR and non-DPGR. A Specified Cooperative that does not have information readily available to specifically identify COGS allocable to DPGR and that cannot, without undue burden or expense, specifically identify that amount is not required to use a method that specifically identifies COGS allocable to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of COGS between DPGR and non-DPGR. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for COGS must be consistent with any allocations under this paragraph (b)(2).

(ii) *Gross receipts recognized in an earlier taxable year.* If the Specified Cooperative (other than a Specified Cooperative that uses the small business simplified overall method of paragraph (f) of this section) recognizes and reports gross receipts on a Federal income tax return for a taxable year, and incurs COGS related to such gross receipts in a subsequent taxable year, then regardless of whether the gross receipts ultimately qualify as DPGR, the Specified Cooperative must allocate the COGS to—

(A) DPGR if the Specified Cooperative identified the related gross receipts as DPGR in the prior taxable year; or

(B) Non-DPGR if the Specified Cooperative identified the related gross receipts as non-DPGR in the prior taxable year or if the Specified Cooperative recognized under the Specified Cooperative's methods of accounting those gross receipts in a taxable year to which section 199A(g) does not apply.

(iii) *COGS associated with activities undertaken in an earlier taxable year*—(A) *In general*. A Specified Cooperative must allocate its COGS between DPGR and non-DPGR under the rules provided in paragraphs (b)(2)(i) and (iii) of this section, regardless of whether certain costs included in its COGS can be associated with activities undertaken in an earlier taxable year (including a year prior to the effective date of section 199A(g)). A Specified Cooperative may not segregate its COGS into component costs and allocate those component costs between DPGR and non-DPGR.

(B) *Example*. The following example illustrates an application of paragraph (b)(2)(iii)(A) of this section.

(*1*) *Example 1*. During the 2020 taxable year, nonexempt Specified Cooperative X grew and sold Horticultural Product A. All of the patronage gross receipts from sales recognized by X in 2020 were from the sale of Horticultural Product A and qualified as DPGR. Employee 1 of X was involved in X's production process until he retired in 2013. In 2020, X paid $30 directly from its general assets for Employee 1's medical expenses pursuant to an unfunded, self-insured plan for retired X employees. For purposes of computing X's 2020 taxable income, X capitalized those medical costs to inventory under section 263A. In 2020, the COGS for a unit of Horticultural Product A was $100 (including the applicable portion of the $30 paid for Employee 1's medical costs that was allocated to COGS under X's allocation method for additional section 263A costs). X has information readily available to specifically identify COGS allocable to DPGR and can identify that amount without undue burden and expense because all of X's gross receipts from sales in 2020 are attributable to the sale of Horticultural Product A and qualify as DPGR. The inventory cost of each unit of Horticultural Product A sold in 2020, including the applicable portion of retiree medical costs, is related to X's gross receipts from the sale of Horticultural Product A in 2020. X may not segregate the 2020 COGS by separately allocating the retiree medical costs, which are components of COGS, to DPGR and non-DPGR. Thus, even though the retiree medical costs can be associated with activities undertaken in prior years, $100 of inventory cost of each unit of Horticultural Product A sold in 2020, including the applicable portion of the retiree medical expense cost component, is allocable to DPGR in 2020.

(3) *Special allocation rules*. Section 199A(g)(3)(C) provides the following two special rules—

(i) For purposes of determining the COGS that are allocable to DPGR, any item or service brought into the United States (defined in §1.199A–9(i)) is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the United States. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to DPGR.

(ii) In the case of any property described in paragraph (b)(3)(i) of this section that has been exported by the Specified Cooperative for further manufacture, the increase in cost or adjusted basis under paragraph (b)(3)(i) of this section cannot exceed the difference between the value of the property when exported and the value of the property when brought back into the United States after the further manufacture. For the purposes of this paragraph (b)(3), the value of property is its customs value as defined in section 1059A(b)(1).

(4) *Rules for inventories valued at market or bona fide selling prices*. If part of COGS is attributable to the Specified Cooperative's inventory valuation adjustments, then COGS allocable to DPGR includes inventory adjustments to agricultural or horticultural products that are MPGE in whole or significant part within the United States. Accordingly, a Specified Cooperative that values its inventory under §1.471–4 (inventories at cost or market, whichever is lower) or §1.471–2(c) (subnormal goods at bona fide selling prices) must allocate a proper share of such adjustments (for example, write-downs) to DPGR based on a reasonable method based on all the facts and circumstances. Factors taken into account in determining whether the

method is reasonable include whether the Specified Cooperative uses the most accurate information available; the relationship between the adjustment and the allocation base chosen; the accuracy of the method chosen as compared with other possible methods; whether the method is used by the Specified Cooperative for internal management or other business purposes; whether the method is used for other Federal or state income tax purposes; the time, burden, and cost of using alternative methods; and whether the Specified Cooperative applies the method consistently from year to year. If the Specified Cooperative has information readily available to specifically identify the proper amount of inventory valuation adjustments allocable to DPGR, then the Specified Cooperative must allocate that amount to DPGR. The Specified Cooperative that does not have information readily available to specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR and that cannot, without undue burden or expense, specifically identify the proper amount of its inventory valuation adjustments allocable to DPGR, is not required to use a method that specifically identifies inventory valuation adjustments to DPGR. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect inventory adjustments. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for inventory adjustments must be consistent with any allocations under this paragraph (b)(4).

(5) *Rules applicable to inventories accounted for under the last-in, first-out inventory method*—(i) *In general.* This paragraph (b)(5) applies to inventories accounted for using the specific goods last-in, first-out (LIFO) method or the dollar-value LIFO method. Whenever a specific goods grouping or a dollar-value pool contains agricultural or horticultural products that produce DPGR and goods that do not, the Specified Cooperative must allocate COGS attributable to that grouping or pool between DPGR and non-DPGR using a reasonable method based on all the facts and circumstances. Whether a method of allocating COGS between DPGR and non-DPGR is reasonable must be determined in accordance with paragraph (b)(2) of this section. In addition, this paragraph (b)(5) provides methods that a Specified Cooperative may use to allocate COGS for a Specified Cooperative's inventories accounted for using the LIFO method. If the Specified Cooperative uses the LIFO/FIFO ratio method provided in paragraph (b)(5)(ii) of this section or the change in relative base-year cost method provided in paragraph (b)(5)(iii) of this section, then the Specified Cooperative must use that method for all of the Specified Cooperative's inventory accounted for under the LIFO method. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the inventory method. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for the inventory method must be consistent with any allocations under this paragraph (b)(5).

(ii) *LIFO/FIFO ratio method.* The LIFO/FIFO ratio method is applied with respect to the LIFO inventory on a grouping-by-grouping or pool-by-pool basis. Under the LIFO/FIFO ratio method, a Specified Cooperative computes the COGS of a grouping or pool allocable to DPGR by multiplying the COGS of agricultural or horticultural products (defined in §1.199A–8(a)(4)) in the grouping or pool that produced DPGR computed using the FIFO method by the LIFO/FIFO ratio of the grouping or pool. The LIFO/FIFO ratio of a grouping or pool is equal to the total COGS of the grouping or pool computed using the LIFO method over the total COGS of the grouping or pool computed using the FIFO method.

(iii) *Change in relative base-year cost method.* A Specified Cooperative using the dollar-value LIFO method may use the change in relative base-year cost method. The change in relative base-year cost method for a Specified Cooperative using the dollar-value LIFO method is applied to all LIFO inventory on a pool-by-pool basis. The change in relative base-year cost method determines the COGS allocable to

DPGR by increasing or decreasing the total production costs (section 471 costs and additional section 263A costs) of agricultural or horticultural products that generate DPGR by a portion of any increment or liquidation of the dollar-value pool. The portion of an increment or liquidation allocable to DPGR is determined by multiplying the LIFO value of the increment or liquidation (expressed as a positive number) by the ratio of the change in total base-year cost (expressed as a positive number) of agricultural or horticultural products that will generate DPGR in ending inventory to the change in total base-year cost (expressed as a positive number) of all goods in ending inventory. The portion of an increment or liquidation allocable to DPGR may be zero but cannot exceed the amount of the increment or liquidation. Thus, a ratio in excess of 1.0 must be treated as 1.0.

(6) *Specified Cooperative using a simplified method for additional section 263A costs to ending inventory.* A Specified Cooperative that uses a simplified method specifically described in the section 263A regulations to allocate additional section 263A costs to ending inventory must follow the rules in paragraph (b)(2) of this section to determine the amount of additional section 263A costs allocable to DPGR. Allocable additional section 263A costs include additional section 263A costs included in the Specified Cooperative's beginning inventory as well as additional section 263A costs incurred during the taxable year by the Specified Cooperative. Ordinarily, if the Specified Cooperative uses a simplified method specifically described in the section 263A regulations to allocate its additional section 263A costs to its ending inventory, the additional section 263A costs must be allocated in the same proportion as section 471 costs are allocated.

(c) *Other deductions properly allocable to DPGR or gross income attributable to DPGR*—(1) *In general.* In determining its QPAI, the Specified Cooperative must subtract from its DPGR (in addition to the COGS), the deductions that are properly allocable and apportioned to DPGR. A Specified Cooperative generally must allocate and apportion these deductions using the rules of the section 861 method provided in paragraph (d) of this section. In lieu of the section 861 method, an eligible Specified Cooperative may apportion these deductions using the simplified deduction method provided in paragraph (e) of this section. Paragraph (f) of this section provides a small business simplified overall method that may be used by a qualifying small Specified Cooperative. A Specified Cooperative using the simplified deduction method or the small business simplified overall method must use that method for all deductions. A Specified Cooperative eligible to use the small business simplified overall method may choose at any time for any taxable year to use the small business simplified overall method or the simplified deduction method for a taxable year.

(2) *Treatment of net operating losses.* A deduction under section 172 for a net operating loss (NOL) is not allocated or apportioned to DPGR or gross income attributable to DPGR.

(3) *W–2 wages.* Although only W–2 wages as described in §1.199A–11 are taken into account in computing the W–2 wage limitation, all wages paid (or incurred in the case of an accrual method taxpayer) in the taxable year are taken into account in computing QPAI for that taxable year.

(d) *Section 861 method.* Under the section 861 method, the Specified Cooperative must allocate and apportion its deductions using the allocation and apportionment rules provided under the section 861 regulations under which section 199A(g) is treated as an operative section described in §1.861–8(f). Accordingly, the Specified Cooperative applies the rules of the section 861 regulations to allocate and apportion deductions (including, if applicable, its distributive share of deductions from passthrough entities) to gross income attributable to DPGR. If the Specified Cooperative applies the allocation and apportionment rules of the section 861 regulations for section 199A(g) and another operative section, then the Specified Cooperative must use the same method of allocation and the same principles of apportionment for purposes of all operative sections. Research and experimental expenditures must be allocated and apportioned in accordance with § 1.861–17 without taking into account the exclusive apportionment rule of § 1.861–17(b). Deductions for charitable contributions (as allowed under section 170 and section 873(b)(2) or 882(c)(1)(B)) must be ratably apportioned between gross income attributable to DPGR and gross income attributable to non-DPGR based on the relative amounts of gross income.

(e) *Simplified deduction method*—(1) *In general.* An eligible Specified Cooperative (defined in paragraph (e)(2) of this section) may use the simplified deduction method to apportion business deductions between DPGR and non-DPGR. The simplified deduction method does not apply to COGS. Under the simplified deduction method, the business deductions (except the NOL deduction) are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of deductions for the current taxable year apportioned to DPGR is equal to the proportion of the total business deductions for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) *Eligible Specified Cooperative.* For purposes of this paragraph (e), an eligible Specified Cooperative is—

(i) A Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $100,000,000 or less; or

(ii) A Specified Cooperative that has total assets (as defined in paragraph (e)(3) of this section) of $10,000,000 or less.

(3) *Total assets.*—(i) *In general.* For purposes of the simplified deduction method, total assets mean the total assets the Specified Cooperative has at the end of the taxable year.

(ii) *Members of an expanded affiliated group.* To compute the total assets of an *expanded affiliated group* (EAG) at the end of the taxable year, the total assets at the end of the taxable year of each member of the EAG at the end of the taxable year that ends with or within the taxable year of the computing member (as described in § 1.199A–12(g)) are aggregated.

(4) *Members of an expanded affiliated group*—(i) *In general.* Whether the members of an EAG may use the simplified deduction method is determined by reference to all the members of the EAG. If the average annual gross receipts of the EAG are less than or equal to $100,000,000 or the total assets of the EAG are less than or equal to $10,000,000, then each member of the EAG may individually determine whether to use the simplified deduction method, regardless of the cost allocation method used by the other members.

(ii) *Exception.* Notwithstanding paragraph (e)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(f) *Small business simplified overall method*—(1) *In general.* A qualifying small Specified Cooperative may use the small business simplified overall method to apportion COGS and deductions between DPGR and non-DPGR. Under the small business simplified overall method, a Specified Cooperative's total costs for the current taxable year (as defined in paragraph (f)(3) of this section) are apportioned between DPGR and non-DPGR based on relative gross receipts. Accordingly, the amount of total costs for the current taxable year apportioned to DPGR is equal to the proportion of total costs for the current taxable year that the amount of DPGR bears to total gross receipts.

(2) *Qualifying small Specified Cooperative.* For purposes of this paragraph (f), a qualifying small Specified Cooperative is a Specified Cooperative that has average annual total gross receipts (as defined in paragraph (g) of this section) of $25,000,000 or less.

(3) *Total costs for the current taxable year.* For purposes of the small business simplified overall method, total costs for the current taxable year means the total COGS and deductions for the current taxable year. Total costs for the current taxable year are determined under the methods of accounting that the Specified Cooperative uses to compute taxable income.

(4) *Members of an expanded affiliated group*—(i) *In general.* Whether the members of an EAG may use the small business simplified overall method is determined by reference to all the members of the EAG. If the average annual gross

receipts of the EAG are less than or equal to $25,000,000 then each member of the EAG may individually determine whether to use the small business simplified overall method, regardless of the cost allocation method used by the other members.

(ii) *Exception.* Notwithstanding paragraph (f)(4)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(g) *Average annual gross receipts*—(1) *In general.* For purposes of the simplified deduction method and the small business simplified overall method, average annual gross receipts means the average annual gross receipts of the Specified Cooperative for the 3 taxable years (or, if fewer, the taxable years during which the taxpayer was in existence) preceding the current taxable year, even if one or more of such taxable years began before the effective date of section 199A(g). In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts of the Specified Cooperative are annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(2) *Members of an expanded affiliated group*—(i) *In general.* To compute the average annual gross receipts of an EAG, the gross receipts for the entire taxable year of each member that is a member of the EAG at the end of its taxable year that ends with or within the taxable year are aggregated. For purposes of this paragraph (g)(2), a consolidated group is treated as one member of an EAG.

(ii) *Exception.* Notwithstanding paragraph (g)(1)(i) of this section, all members of the same consolidated group must use the same cost allocation method.

(h) *Cost allocation methods for determining oil-related QPAI*—(1) *Section 861 method.* A Specified Cooperative that uses the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to DPGR must use the section 861 method to determine deductions that are allocated and apportioned to gross income attributable to oil-related DPGR.

(2) *Simplified deduction method.* A Specified Cooperative that uses the simplified deduction method to apportion deductions between DPGR and non-DPGR must determine the portion of deductions allocable to oil-related DPGR by multiplying the deductions allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(3) *Small business simplified overall method.* A Specified Cooperative that uses the small business simplified overall method to apportion total costs (COGS and deductions) between DPGR and non-DPGR must determine the portion of total costs allocable to oil-related DPGR by multiplying the total costs allocable to DPGR by the ratio of oil-related DPGR to DPGR from all activities.

(i) *Applicability date.* The provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§ 1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

[T.D. 9947, 86 FR 5569, Jan. 19, 2021]

§ 1.199A–11 Wage limitation for the section 199A(g) deduction.

(a) *Rules of application*—(1) *In general.* The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). The provisions of this section provide guidance on determining the W–2 wage limitation as defined in § 1.199A–8(b)(5)(ii)(B). Except as provided in paragraph (d)(2) of this section, the Form W–2, Wage and Tax Statement, or any subsequent form or document used in determining the amount of W–2 wages, are those issued for the calendar year ending during the taxable year of the Specified Cooperative (defined in § 1.199A–8(a)(2)) for wages paid to employees (or former employees) of the Specified Cooperative for employment by the Specified Cooperative. Employees are limited to employees defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules). See paragraph (a)(5) of this section for the requirement that W–2 wages must have been included in a return filed with the Social Security Administration (SSA) within 60 days after the due date (including extensions) of the return. *See also* section 199A(a)(4)(C).

(2) *Wage limitation for section 199A(g) deduction.* The amount of the deduction allowable under section 199A(g) to the Specified Cooperative for any taxable year cannot exceed 50 percent of the W–2 wages (as defined in section 199A(g)(1)(B)(ii) and paragraph (b) of this section) for the taxable year that are attributable to domestic production gross receipts (DPGR), defined in §1.199A–8(b)(3)(ii), of agricultural or horticultural products defined in §1.199A–8(a)(4).

(3) *Wages paid by entity other than common law employer.* In determining W–2 wages, the Specified Cooperative may take into account any W–2 wages paid by another entity and reported by the other entity on Forms W–2 with the other entity as the employer listed in Box c of the Forms W–2, provided that the W–2 wages were paid to common law employees or officers of the Specified Cooperative for employment by the Specified Cooperative. In such cases, the entity paying the W–2 wages and reporting the W–2 wages on Forms W–2 is precluded from taking into account such wages for purposes of determining W–2 wages with respect to that entity. For purposes of this paragraph (a)(4), entities that pay and report W–2 wages on behalf of or with respect to other taxpayers can include, but are not limited to, certified professional employer organizations under section 7705, statutory employers under section 3401(d)(1), and agents under section 3504.

(4) *Requirement that wages must be reported on return filed with the Social Security Administration*—(i) *In general.* Pursuant to section 199A(g)(1)(B)(ii) and section 199A(b)(4)(C), the term W–2 wages does not include any amount that is not properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return. Under §31.6051–2 of this chapter, each Form W–2 and the transmittal Form W–3, Transmittal of Wage and Tax Statements, together constitute an information return to be filed with SSA. Similarly, each Form W–2c, Corrected Wage and Tax Statement, and the transmittal Form W–3 or W–3c, Transmittal of Corrected Wage and Tax Statements, together constitute an information return to be filed with SSA. In determining whether any amount has been properly included in a return filed with SSA on or before the 60th day after the due date (including extensions) for such return, each Form W–2 together with its accompanying Form W–3 is considered a separate information return and each Form W–2c together with its accompanying Form W–3 or Form W–3c is considered a separate information return. Section 6071(c) provides that Forms W–2 and W–3 must be filed on or before January 31 of the year following the calendar year to which such returns relate (but see the special rule in §31.6071(a)–1T(a)(3)(1) of this chapter for monthly returns filed under §31.6011(a)–5(a) of this chapter). Corrected Forms W–2 are required to be filed with SSA on or before January 31 of the year following the year in which the correction is made.

(ii) *Corrected return filed to correct a return that was filed within 60 days of the due date.* If a corrected information return (Return B) is filed with SSA on or before the 60th day after the due date (including extensions) of Return B to correct an information return (Return A) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return A) and paragraph (a)(5)(iii) of this section does not apply, then the wage information on Return B must be included in determining W–2 wages. If a corrected information return (Return D) is filed with SSA later than the 60th day after the due date (including extensions) of Return D to correct an information return (Return C) that was filed with SSA on or before the 60th day after the due date (including extensions) of the information return (Return C), then if Return D reports an increase (or increases) in wages included in determining W–2 wages from the wage amounts reported on Return C, such increase (or increases) on Return D is disregarded in determining W–2 wages (and only the wage amounts on Return C may be included in determining W–2 wages). If Return D reports a decrease (or decreases) in wages included in determining W–2 wages from the amounts reported on Return C, then, in determining W–2 wages, the wages reported on Return C must be reduced by the decrease (or decreases) reflected on Return D.

(iii) *Corrected return filed to correct a return that was filed later than 60 days after the due date.* If an information return (Return F) is filed to correct an information return (Return E) that was not filed with SSA on or before the 60th day after the due date (including extensions) of Return E, then Return F (and any subsequent information returns filed with respect to Return E) will not be considered filed on or before the 60th day after the due date (including extensions) of Return F (or the subsequent corrected information return). Thus, if a Form W–2c is filed to correct a Form W–2 that was not filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2 (or to correct a Form W–2c relating to a Form W–2 that had not been filed with SSA on or before the 60th day after the due date (including extensions) of the Form W–2), then this Form W–2c is not to be considered to have been filed with SSA on or before the 60th day after the due date (including extensions) for this Form W–2c, regardless of when the Form W–2c is filed.

(b) *Definition of W–2 wages*—(1) *In general.* Section 199A(g)(1)(B)(ii) provides that the W–2 wages of the Specified Cooperative must be determined in the same manner as under section 199A(b)(4) (without regard to section 199A(b)(4)(B) and after application of section 199A(b)(5)). Section 199A(b)(4)(A) provides that the term W–2 wages means with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year. Thus, the term W–2 wages includes the total amount of wages as defined in section 3401(a); the total amount of elective deferrals (within the meaning of section 402(g)(3)); the compensation deferred under section 457; and the amount of designated Roth contributions (as defined in section 402A).

(2) *Section 199A(g) deduction.* Pursuant to section 199A(g)(3)(A), W–2 wages do not include any amount which is not properly allocable to DPGR for purposes of calculating qualified production activities income (QPAI) as defined in §1.199A–8(b)(4)(ii). The Specified Cooperative may determine the amount of wages that is properly allocable to DPGR using a reasonable method based on all the facts and circumstances. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the wages allocable to DPGR for purposes of QPAI. The books and records maintained for wages allocable to DPGR for purposes of QPAI must be consistent with any allocations under this paragraph (b)(2).

(c) *Methods for calculating W–2 wages.* The Secretary may provide for methods that may be used in calculating W–2 wages, including W–2 wages for short taxable years by publication in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii)(b) of this chapter).

(d) *Wage limitation—acquisitions, dispositions, and short taxable years*—(1) *In general.* For purposes of computing the deduction under section 199A(g) of the Specified Cooperative, in the case of an acquisition or disposition (as defined in section 199A(b)(5) and paragraph (d)(3) of this section) that causes more than one Specified Cooperative to be an employer of the employees of the acquired or disposed of Specified Cooperative during the calendar year, the W–2 wages of the Specified Cooperative for the calendar year of the acquisition or disposition are allocated between or among each Specified Cooperative based on the period during which the employees of the acquired or disposed of Specified Cooperatives were employed by the Specified Cooperative, regardless of which permissible method is used for reporting predecessor and successor wages on Form W–2, Wage and Tax Statement.

(2) *Short taxable year that does not include December 31.* If the Specified Cooperative has a short taxable year that does not contain a calendar year ending during such short taxable year, wages paid to employees for employment by the Specified Cooperative during the short taxable year are treated as W–2 wages for such short taxable year for purposes of paragraph (a) of this section (if the wages would otherwise meet the requirements to be W–2 wages under this section but for the requirement that a calendar year must end during the short taxable year).

(3) *Acquisition or disposition.* For purposes of paragraph (d)(1) and (2) of this section, the terms *acquisition* and *disposition* include an incorporation, a liquidation, a reorganization, or a purchase or sale of assets.

(e) *Application in the case of a Specified Cooperative with a short taxable year.* In the case of a Specified Cooperative with a short taxable year, subject to the rules of paragraph (a) of this section, the W–2 wages of the Specified Cooperative for the short taxable year can include only those wages paid during the short taxable year to employees of the Specified Cooperative, only those elective deferrals (within the meaning of section 402(g)(3)) made during the short taxable year by employees of the Specified Cooperative, and only compensation actually deferred under section 457 during the short taxable year with respect to employees of the Specified Cooperative.

(f) *Non-duplication rule.* Amounts that are treated as W–2 wages for a taxable year under any method cannot be treated as W–2 wages of any other taxable year. Also, an amount cannot be treated as W–2 wages by more than one taxpayer. Finally, an amount cannot be treated as W–2 wages by the Specified Cooperative both in determining patronage and nonpatronage W–2 wages.

(g) *Wage expense safe harbor*—(1) *In general.* A Specified Cooperative using either the section 861 method of cost allocation under §1.199A–10(d) or the simplified deduction method under §1.199A–10(e) may determine the amount of W–2 wages that are properly allocable to DPGR for a taxable year by multiplying the amount of W–2 wages determined under paragraph (b)(1) of this section for the taxable year by the ratio of the Specified Cooperative's wage expense included in calculating QPAI for the taxable year to the Specified Cooperative's total wage expense used in calculating the Specified Cooperative's taxable income for the taxable year, without regard to any wage expense disallowed by section 465, 469, 704(d), or 1366(d). A Specified Cooperative that uses either the section 861 method of cost allocation or the simplified deduction method to determine QPAI must use the same expense allocation and apportionment methods that it uses to determine QPAI to allocate and apportion wage expense for purposes of this safe harbor. For purposes of this paragraph (g)(1), the term wage expense means wages (that is, compensation paid by the employer in the active conduct of a trade or business to its employees) that are properly taken into account under the Specified Cooperative's method of accounting.

(2) *Wage expense included in cost of goods sold.* For purposes of paragraph (g)(1) of this section, a Specified Cooperative may determine its wage expense included in cost of goods sold (COGS) using a reasonable method based on all the facts and circumstances, such as using the amount of direct labor included in COGS or using section 263A labor costs (as defined in §1.263A–1(h)(4)(ii)) included in COGS. The chosen reasonable method must be consistently applied from one taxable year to another and must clearly reflect the portion of wage expense included in COGS. The method must also be reasonable based on all the facts and circumstances. The books and records maintained for wage expense included in COGS must be consistent with any allocations under this paragraph (g)(2).

(3) *Small business simplified overall method safe harbor.* The Specified Cooperative that uses the small business simplified overall method under §1.199A–10(f) may use the small business simplified overall method safe harbor for determining the amount of W–2 wages determined under paragraph

(b)(1) of this section that is properly allocable to DPGR. Under this safe harbor, the amount of W–2 wages determined under paragraph (b)(1) of this section that is properly allocable to DPGR is equal to the same proportion of W–2 wages determined under paragraph (b)(1) of this section that the amount of DPGR bears to the Specified Cooperative's total gross receipts.

(h) *Applicability date.* The provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

[T.D. 9947, 86 FR 5569, Jan. 19, 2021]

§ 1.199A–12 Expanded affiliated groups.

(a) *In general.* The provisions of this section apply solely for purposes of section 199A(g) of the Internal Revenue Code (Code). Except as otherwise provided in the Code or regulations issued under the relevant section of the Code (for example, sections 199A(g)(3)(D)(ii) and 267, §1.199A–8(c), paragraph (a)(3) of this section, and the consolidated return regulations under section 1502), each nonexempt Specified Cooperative (defined in §1.199A–8(a)(2)(ii)) that is a member of an expanded affiliated group (EAG) (defined in paragraph (a)(1) of this section) computes its own taxable income or loss, qualified production activities income (QPAI) (defined in §1.199A–8(b)(4)(ii)), and W–2 wages (defined in §1.199A–11(b)). For purposes of this section unless otherwise specified, the term *Specified Cooperative* means a nonexempt Specified Cooperative. If a Specified Cooperative is also a member of a consolidated group, see paragraph (d) of this section.

(1) *Definition of an expanded affiliated group.* An EAG is an affiliated group as defined in section 1504(a), determined by substituting ''more than 50 percent'' for ''at least 80 percent'' in each place it appears and without regard to section 1504(b)(2) and (4).

(2) *Identification of members of an expanded affiliated group*—(i) *In general.* Each Specified Cooperative must determine if it is a member of an EAG on a daily basis.

(ii) *Becoming or ceasing to be a member of an expanded affiliated group.* If a Specified Cooperative becomes or ceases to be a member of an EAG, the Specified Cooperative is treated as becoming or ceasing to be a member of the EAG at the end of the day on which its status as a member changes.

(3) *Attribution of activities*—(i) *In general.* Except as provided in paragraph (a)(3)(iv) of this section, if a Specified Cooperative that is a member of an EAG (disposing member) derives gross receipts (defined in §1.199A–8(b)(2)(iii)) from the lease, rental, license, sale, exchange, or other disposition (defined in §1.199A–9(j)) of agricultural or horticultural products (defined in §1.199A–8(a)(4)) that were manufactured, produced, grown or extracted (MPGE) (defined in §1.199A–9(f)), in whole or significant part (defined in §1.199A–9(h)), in the United States (defined in §1.199A–9(i)) by another Specified Cooperative, then the disposing member is treated as conducting the previous activities conducted by such other Specified Cooperative with respect to the agricultural or horticultural products in determining whether its gross receipts are domestic production gross receipts (DPGR) (defined in §1.199A–8(b)(3)(ii)) if—

(A) Such property was MPGE by such other Specified Cooperative, and

(B) The disposing member is a member of the same EAG as such other Specified Cooperative at the time that the disposing member disposes of the agricultural or horticultural products.

(ii) *Date of disposition for leases, rentals, or licenses.* Except as provided in paragraph (a)(3)(iv) of this section, with respect to a lease, rental, or license, the disposing member described in paragraph (a)(3)(i) of this section is treated as having disposed of the agricultural or horticultural products on the date or dates on which it takes into account the gross receipts derived from the lease, rental, or license under its methods of accounting.

(iii) *Date of disposition for sales, exchanges, or other dispositions.* Except as provided in paragraph (a)(3)(iv) of this section, with respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the agricultural or horticultural products on the date on which it ceases to own the agricultural or horticultural products for Federal income tax purposes, even if no gain or loss is taken into account.

(iv) *Exception*. A Specified Cooperative is not attributed nonpatronage activities conducted by another Specified Cooperative. *See* § 1.199A–8(b)(2)(ii).

(4) *Marketing Specified Cooperatives*. A Specified Cooperative is treated as having MPGE in whole or significant part any agricultural or horticultural product within the United States marketed by the Specified Cooperative which its patrons have so MPGE. Patrons are defined in § 1.1388–1(e).

(5) *Anti-avoidance rule*. If a transaction between members of an EAG is engaged in or structured with a principal purpose of qualifying for, or increasing the amount of, the section 199A(g) deduction of the EAG or the portion of the section 199A(g) deduction allocated to one or more members of the EAG, the Secretary may make adjustments to eliminate the effect of the transaction on the computation of the section 199A(g) deduction.

(b) *Computation of EAG's section 199A(g) deduction*.—(1) *In general*. The section 199A(g) deduction for an EAG is determined by separately computing the section 199A(g) deduction from the patronage sources of Specified Cooperatives that are members of the EAG. The section 199A(g) deduction from patronage sources of Specified Cooperatives is determined by aggregating the income or loss, QPAI, and W–2 wages, if any, of each patronage source of a Specified Cooperative that is a member of the EAG. For purposes of this determination, a member's QPAI may be positive or negative. A Specified Cooperative's taxable income or loss and QPAI is determined by reference to the Specified Cooperative's method of accounting. For purposes of determining the section 199A(g) deduction for an EAG, taxable income or loss, QPAI, and W–2 wages of a Specified Cooperative from nonpatronage sources are considered to be zero, other than as allowed under § 1.199A–8(b)(2)(ii).

(2) *Example*. The following example illustrates the application of paragraph (b)(1) of this section.

(i) *Facts*. Nonexempt Specified Cooperatives X, Y, and Z, calendar year taxpayers, are the only members of an EAG and are not members of a consolidated group. X has patronage source taxable income of $50,000, QPAI of $15,000, and W–2 wages of $0. Y has patronage source taxable income of ($20,000), QPAI of ($1,000), and W–2 wages of $750. Z has patronage source taxable income of $0, QPAI of $0, and W–2 wages of $3,000.

(ii) *Analysis*. In determining the EAG's section 199A(g) deduction, the EAG aggregates each member's patronage source taxable income or loss, QPAI, and W–2 wages. Thus, the EAG has patronage source taxable income of $30,000, the sum of X's patronage source taxable income of $50,000, Y's patronage source taxable income of ($20,000), and Z's patronage source taxable income of $0. The EAG has QPAI of $14,000, the sum of X's QPAI of $15,000, Y's QPAI of ($1,000), and Z's QPAI of $0. The EAG has W–2 wages of $3,750, the sum of X's W–2 wages of $0, Y's W–2 wages of $750, and Z's W–2 wages of $3,000. Accordingly, the EAG's section 199A(g) deduction equals $1,260, 9% of $14,000, the lesser of the QPAI and patronage source taxable income, but not greater than $1,875, 50% of its W–2 wages of $3,750. This result would be the same if X had a nonpatronage source income or loss, because nonpatronage source income of a nonexempt Specified Cooperative is not taken into account in determining the section 199A(g) deduction.

(3) *Net operating loss carryovers/carrybacks*. In determining the taxable income of an EAG, if a Specified Cooperative has a net operating loss (NOL) from its patronage sources that may be carried over or carried back (in accordance with section 172) to the taxable year, then for purposes of determining the taxable income of the Specified Cooperative, the amount of the NOL used to offset taxable income cannot exceed the taxable income of the patronage source of that Specified Cooperative.

(4) *Losses used to reduce taxable income of an expanded affiliated group.* The amount of an NOL sustained by a Specified Cooperative member of an EAG that is used in the year sustained in determining an EAG's taxable income limitation under § 1.199A–8(b)(5)(ii)(C) is not treated as an NOL carryover to any taxable year in determining the taxable income limitation under § 1.199A–8(b)(5)(ii)(C). For purposes of this paragraph (b)(4), an NOL is considered to be used if it reduces an EAG's aggregate taxable income from patronage sources or nonpatronage sources, as the case may be, regardless of whether the use of the NOL actually reduces the amount of the section 199A(g) deduction that the EAG would otherwise derive. An NOL is not considered to be used to the extent that it reduces an EAG's aggregate taxable income from patronage sources to an amount less than zero. If more than one Specified Cooperative has an NOL used in the same taxable year to reduce the EAG's taxable income from patronage sources, the respective NOLs are deemed used in proportion to the amount of each Specified Cooperative's NOL.

(5) *Example.* The following example illustrates the application of paragraph (b)(4) of this section.

(i) *Facts.* Nonexempt Specified Cooperatives A and B are the only two members of an EAG. A and B are both calendar year taxpayers and they do not join in the filing of a consolidated Federal income tax return. Neither A nor B had taxable income or loss prior to 2020. In 2020, A has patronage QPAI and patronage taxable income of $1,000 and B has patronage QPAI of $1,000 and a patronage NOL of $1,500. A also has nonpatronage income of $3,000. B has no activities other than from its patronage activities. In 2021, A has patronage QPAI of $2,000 and patronage taxable income of $1,000 and B has patronage QPAI of $2,000 and patronage taxable income prior to the NOL deduction allowed under section 172 of $2,000. Neither A nor B has nonpatronage activities in 2021. A's and B's patronage activities have aggregate W–2 wages in excess of the section 199A(g)(1)(B) wage limitation in both 2020 and 2021.

(ii) *Section 199A(g) deduction for 2020.* In determining the EAG's section 199A(g) deduction for 2020, A's $1,000 of QPAI and B's $1,000 of QPAI are aggregated, as are A's $1,000 of taxable income from its patronage activities and B's $1,500 NOL from its patronage activities. A's nonpatronage income is not included. Thus, for 2020, the EAG has patronage QPAI of $2,000 and patronage taxable income of ($500). The EAG's section 199A(g) deduction for 2020 is 9% of the lesser of its patronage QPAI or its patronage taxable income. Because the EAG has a taxable loss from patronage sources in 2020, the EAG's section 199A(g) deduction is $0.

(iii) *Section 199A(a) deduction for 2021.* In determining the EAG's section 199A deduction for 2021, A's patronage QPAI of $2,000 and B's patronage QPAI of $2,000 are aggregated, resulting in the EAG having patronage QPAI of $4,000. Also, $1,000 of B's patronage NOL from 2020 was used in 2020 to reduce the EAG's taxable income from patronage sources to $0. The remaining $500 of B's patronage NOL from 2020 is not considered to have been used in 2020 because it reduced the EAG's patronage taxable income to less than $0. Accordingly, for purposes of determining the EAG's taxable income limitation under § 1.199A–8(b)(5) in 2021, B is deemed to have only a $500 NOL carryover from its patronage sources from 2020 to offset a portion of its 2021 taxable income from its patronage sources. Thus, B's taxable income from its patronage sources in 2021 is $1,500, which is aggregated with A's $1,000 of taxable income from its patronage sources. The EAG's taxable income limitation in 2021 is $2,500. The EAG's section 199A(g) deduction is 9% of the lesser of its patronage sourced QPAI of $4,000 and its taxable income from patronage sources of $2,500. Thus, the EAG's section 199A(g) deduction in 2021 is 9% of $2,500, or $225. The results for 2021 would be the same if neither A nor B had patronage sourced QPAI in 2020.

(c) *Allocation of an expanded affiliated group's section 199A(g) deduction among members of the expanded affiliated group*—(1) *In general.* An EAG's section 199A(g) deduction from its patronage sources, as determined in paragraph (b) of this section, is allocated among the

Specified Cooperatives that are members of the EAG in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage taxable income or W–2 wages for the taxable year. For these purposes, if a Specified Cooperative has negative patronage QPAI, such QPAI is treated as zero. Pursuant to §1.199A–8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions.

(2) *Use of section 199A(g) deduction to create or increase a net operating loss.* If a Specified Cooperative that is a member of an EAG has some or all of the EAG's section 199A(g) deduction allocated to it under paragraph (c)(1) of this section and the amount allocated exceeds patronage taxable income, determined as described in this section and prior to allocation of the section 199A(g) deduction, the section 199A(g) deduction will create an NOL for the patronage source. Similarly, if a Specified Cooperative that is a member of an EAG, prior to the allocation of some or all of the EAG's section 199A(g) deduction to the member, has a patronage NOL for the taxable year, the portion of the EAG's section 199A(g) deduction allocated to the member will increase such NOL.

(d) *Special rules for members of the same consolidated group*—(1) *Intercompany transactions.* In the case of an intercompany transaction between consolidated group members S and B (as the terms intercompany transaction, S, and B are defined in §1.1502–13(b)(1)), S takes the intercompany transaction into account in computing the section 199A(g) deduction at the same time and in the same proportion as S takes into account the income, gain, deduction, or loss from the intercompany transaction under §1.1502–13.

(2) *Application of the simplified deduction method and the small business simplified overall method.* For purposes of applying the simplified deduction method under §1.199A–10(e) and the small business simplified overall method under §1.199A–10(f), a Specified Cooperative that is part of a consolidated group determines its QPAI using its members' DPGR, non-DPGR, cost of goods sold (COGS), and all other deductions, expenses, or losses (hereinafter deductions), determined after the application of §1.1502–13.

(3) *Determining the section 199A(g) deduction*—(i) *Expanded affiliated group consists of consolidated group and non-consolidated group members.* In determining the section 199A(g) deduction, if an EAG includes Specified Cooperatives that are members of the same consolidated group and Specified Cooperatives that are not members of the same consolidated group, the consolidated taxable income or loss, QPAI, and W–2 wages, from patronage sources, if any, of the consolidated group (and not the separate taxable income or loss, QPAI, and W–2 wages from patronage sources of the members of the consolidated group), are aggregated with the taxable income or loss, QPAI, and W–2 wages, from patronage sources, if any, of the non-consolidated group members. For example, if A, B, C, S1, and S2 are Specified Cooperatives that are members of the same EAG, and A, S1, and S2 are members of the same consolidated group (the A consolidated group), then the A consolidated group is treated as one member of the EAG. Accordingly, the EAG is considered to have three members—the A consolidated group, B, and C. The consolidated taxable income or loss, QPAI, and W–2 wages from patronage sources, if any, of the A consolidated group are aggregated with the taxable income or loss from patronage sources, QPAI, and W–2 wages, if any, of B and C in determining the EAG's section 199A(g) deduction from patronage sources. Pursuant to §1.199A–8(b)(6), a patronage section 199A(g) deduction can be applied only against patronage income and deductions.

(ii) *Expanded affiliated group consists only of members of a single consolidated group.* If all of the Specified Cooperatives that are members of an EAG are also members of the same consolidated group, the consolidated group's section 199A(g) deduction is determined using the consolidated group's consolidated taxable income or loss, QPAI, and W–2 wages, from patronage sources rather than the separate taxable income or loss, QPAI, and W–2 wages from patronage sources of its members.

(4) *Allocation of the section 199A(g) deduction of a consolidated group among its members.* The section 199A(g) deduction from patronage sources of a consolidated group (or the section 199A(g) deduction allocated to a consolidated group that is a member of an EAG) is allocated among the patronage sources of Specified Cooperatives in proportion to each Specified Cooperative's patronage QPAI, regardless of whether the Specified Cooperative has patronage separate taxable income or W–2 wages for the taxable year. In allocating the section 199A(g) deduction of a patronage source of a Specified Cooperative that is part of a consolidated group among patronage sources of other members of the same group, any redetermination of a member's patronage receipts, COGS, or other deductions from an intercompany transaction under §1.1502–13(c)(1)(i) or (c)(4) is not taken into account for purposes of section 199A(g). Also, for purposes of this allocation, if a patronage source of a Specified Cooperative that is a member of a consolidated group has negative QPAI, the QPAI of the patronage source is treated as zero.

(e) *Examples.* The following examples illustrate the application of paragraphs (a) through (d) of this section.

(1) *Example 1.* Specified Cooperatives X, Y, and Z are members of the same EAG but are not members of a consolidated group. X, Y, and Z each files Federal income tax returns on a calendar year basis. None of X, Y, or Z have activities other than from its patronage sources. Prior to 2020, X had no taxable income or loss. In 2020, X has taxable income of $0, QPAI of $2,000, and W–2 wages of $0, Y has taxable income of $4,000, QPAI of $3,000, and W–2 wages of $500, and Z has taxable income of $4,000, QPAI of $5,000, and W–2 wages of $2,500. Accordingly, the EAG's patronage source taxable income is $8,000, the sum of X's taxable income of $0, Y's taxable income of $4,000, and Z's taxable income of $4,000. The EAG has QPAI of $10,000, the sum of X's QPAI of $2,000, Y's QPAI of $3,000, and Z's QPAI of $5,000. The EAG's W–2 wages are $3,000, the sum of X's W–2 wages of $0, Y's W–2 wages of $500, and Z's W–2 wages of $2,500. Thus, the EAG's section 199A(g) deduction for 2020 is $720 (9% of the lesser of the EAG's patronage source taxable income of $8,000 and the EAG's QPAI of $10,000, but no greater than 50% of its W–2 wages of $3,000, that is $1,500). Pursuant to paragraph (c)(1) of this section, the $720 section 199A(g) deduction is allocated to X, Y, and Z in proportion to their respective amounts of QPAI, that is $144 to X ($720 × $2,000/$10,000), $216 to Y ($720 × $3,000/$10,000), and $360 to Z ($720 × $5,000/$10,000). Although X's patronage source taxable income for 2020 determined prior to allocation of a portion of the EAG's section 199A(g) deduction to it was $0, pursuant to paragraph (c)(2) of this section, X will have an NOL from its patronage source for 2020 equal to $144, which will be a carryover to 2021.

(2) *Example 2.* (i) *Facts.* Corporation X is the common parent of a consolidated group, consisting of X and Y, which has filed a consolidated Federal income tax return for many years. Corporation P is the common parent of a consolidated group, consisting of P and S, which has filed a consolidated Federal income tax return for many years. The X and P consolidated groups each file their consolidated Federal income tax returns on a calendar year basis. X, Y, P, and S are each Specified Cooperatives, and none of X, Y, P, or S has ever had activities other than from its patronage sources. The X consolidated group and the P consolidated group are members of the same EAG in 2021. In 2020, the X consolidated group incurred a consolidated net operating loss (CNOL) of $25,000. Neither P nor S (nor the P consolidated group) has ever incurred an NOL. In 2021, the X consolidated group has (prior to the deduction under section 172) taxable income of $8,000 and the P consolidated group has taxable income of $20,000. X's QPAI is $8,000, Y's QPAI is ($13,000), P's QPAI is $16,000 and S's QPAI is $4,000. There are sufficient W–2 wages to exceed the section 199A(g)(1)(B) limitation.

(ii) *Analysis.* The X consolidated group uses $8,000 of its CNOL from 2020 to offset the X consolidated group's taxable income in 2021. None of the X consolidated group's remaining CNOL may be used to offset taxable income of the P consolidated group under paragraph (b)(3) of this section. Accordingly, for purposes of determining the EAG's section 199A(g) deduction for 2021, the EAG has taxable income of $20,000 (the X consolidated group's taxable income, after the deduction under section 172, of $0 plus the P consolidated group's taxable income of $20,000). The EAG has QPAI of $15,000 (the X consolidated group's QPAI of ($5,000) (X's $8,000 + Y's ($13,000)), and the P consolidated group's QPAI of $20,000 (P's $16,000 + S's $4,000)). The EAG's section 199A(g) deduction equals $1,350, 9% of the lesser of its taxable income of $20,000 and its QPAI of $15,000. The section 199A(g) deduction is allocated between the X and P consolidated groups in proportion to their respective QPAI. Because the X consolidated group has negative QPAI, all of the section 199A(g) deduction of $1,350 is allocated to the P consolidated group. This $1,350 is allocated between P and S, the members of the P consolidated group, in proportion to their QPAI. Accordingly, P is allocated $1,080 ($1,350 × $16,000/$20,000) and S is allocated $270 ($1,350 × $4,000/$20,000).

(f) *Allocation of patronage income and loss by a Specified Cooperative that is a member of the expanded affiliated group for only a portion of the year*—(1) *In general.* A Specified Cooperative that becomes or ceases to be a member of an EAG during its taxable year must allocate its taxable income or loss, QPAI, and W–2 wages between the portion of the taxable year that the Specified Cooperative is a member of the EAG and the portion of the taxable year that the Specified Cooperative is not a member of the EAG. This allocation of items is made by using the pro rata allocation method described in this paragraph (f)(1). Under the pro rata allocation method, an equal portion of patronage taxable income or loss, QPAI, and W–2 wages is assigned to each day of the Specified Cooperative's taxable year. Those items assigned to those days that the Specified Cooperative was a member of the EAG are then aggregated.

(2) *Coordination with rules relating to the allocation of income under §1.1502–76(b).* If §1.1502–76(b) (relating to items included in a consolidated return) applies to a Specified Cooperative that is a member of an EAG, then any allocation of items required under this paragraph (f) is made only after the allocation of the items pursuant to §1.1502–76(b).

(g) *Total section 199A(g) deduction for a Specified Cooperative that is a member of an expanded affiliated group for some or all of its taxable year*—(1) *Member of the same EAG for the entire taxable year.* If a Specified Cooperative is a member of the same EAG for its entire taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year is the amount of the section 199A(g) deduction allocated to it by the EAG under paragraph (c)(1) of this section.

(2) *Member of the expanded affiliated group for a portion of the taxable year.* If a Specified Cooperative is a member of an EAG for only a portion of its taxable year and is either not a member of any EAG or is a member of another EAG, or both, for another portion of the taxable year, the Specified Cooperative's section 199A(g) deduction for the taxable year is the sum of its section 199A(g) deductions for each portion of the taxable year.

(3) *Example.* The following example illustrates the application of paragraphs (f) and (g) of this section.

(i) *Facts.* Specified Cooperatives X and Y, calendar year taxpayers, are members of the same EAG for the entire 2020 taxable year. Specified Cooperative Z, also a calendar year taxpayer, is a member of the EAG of which X and Y are members for the first half of 2020 and not a member of any EAG for the second half of 2020. None of X, Y, or Z have activities other than from its patronage sources. Assume that X, Y, and Z each has W–2 wages in excess of the section 199A(g)(1)(B) wage limitation for all relevant periods. In 2020, X has taxable income of $2,000 and QPAI of $600, Y has taxable loss of $400 and QPAI of ($200), and Z has taxable income of $1,400 and QPAI of $2,400.

(ii) *Analysis.* Pursuant to the pro rata allocation method, $700 of Z's 2020 taxable income and $1,200 of its QPAI are allocated to the first half of the 2020 taxable year (the period in which Z is a member of the EAG) and $700 of Z's 2020 taxable income and $1,200 of its QPAI are allocated to the second half of the 2020 taxable year (the period in which Z is not a member of any EAG). Accordingly, in 2020, the EAG has taxable income from patronage sources of $2,300 ($2,000 + ($400) + $700) and QPAI of $1,600 ($600 + ($200) + $1,200). The EAG's section 199A(g) deduction for 2020 is $144 (9% of the lesser of the EAG's taxable income of $2,300 or QPAI of $1,600). Pursuant to §1.199A–12(c)(1), this $144 deduction is allocated to X, Y, and Z in proportion to their respective QPAI. Accordingly, X is allocated $48 of the EAG's section 199A(g) deduction ($144 × ($600/($600 + $0 + $1,200))), Y is allocated $0 of the EAG's section 199A(g) deduction ($144 × ($0/($600 + $0 + $1,200))), and Z is allocated $96 of the EAG's section 199A(g) deduction ($144 × ($1,200/($600 + $0 + $1,200))). For the second half of 2020, Z has taxable income of $700 and QPAI of $1,200. Therefore, for the second half of 2020, Z has a section 199A(g) deduction of $63 (9% of the lesser of its taxable income of $700 or its QPAI of $1,200). Accordingly, X's 2020 section 199A(g) deduction is $48 and Y's 2020 section 199A(g) deduction is $0. Z's 2020 section 199A(g) deduction is $159, the sum of $96, the portion of the EAG's section 199A(g) deduction allocated to Z for the first half of 2020 and Z's $63 section 199A(g) deduction for the second half of 2020.

(h) *Computation of section 199A(g) deduction for members of an expanded affiliated group with different taxable years*—(1) *In general*. If Specified Cooperatives that are members of an EAG have different taxable years, in determining the section 199A(g) deduction of a member (the computing member), the computing member is required to take into account the taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W–2 wages of each other group member that are both—

(i) Attributable to the period that each other member of the EAG and the computing member are members of the EAG; and

(ii) Taken into account in a taxable year that begins after the effective date of section 199A(g) and ends with or within the taxable year of the computing member with respect to which the section 199A(g) deduction is computed.

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

(i) *Facts*. Specified Cooperatives X, Y, and Z are members of the same EAG. Neither X, Y, nor Z is a member of a consolidated group. X and Y are calendar year taxpayers and Z is a June 30 fiscal year taxpayer. Z came into existence on July 1, 2020. None of X, Y, or Z have activities other than from its patronage sources. Each Specified Cooperative has taxable income that exceeds its QPAI and W–2 wages in excess of the section 199A(g)(1)(B) wage limitation. For the taxable year ending December 31, 2020, X's QPAI is $8,000 and Y's QPAI is ($6,000). For its taxable year ending June 30, 2021, Z's QPAI is $2,000.

(ii) *2020 Computation*. In computing X's and Y's respective section 199A(g) deductions for their taxable years ending December 31, 2020, X's taxable income or loss, QPAI and W–2 wages and Y's taxable income or loss, QPAI, and W–2 wages from their respective taxable years ending December 31, 2020, are aggregated. The EAG's QPAI for this purpose is $2,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000)). Accordingly, the EAG's section 199A(g) deduction is $180 (9% × $2,000). The $180 deduction is allocated to each of X and Y in proportion to their respective QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating the section 199A(g) deduction between X and Y, because Y's QPAI is negative, Y's QPAI is treated as being $0. Accordingly, X's section 199A(g) deduction for its taxable year ending December 31, 2020, is $180 ($180 × $8,000/($8,000 + $0)). Y's section 199A(g) deduction for its taxable year ending December 31, 2020, is $0 ($180 × $0/($8,000 + $0)).

(iii) *2021 Computation*. In computing Z's section 199A(g) deduction for its taxable year ending June 30, 2021, X's and Y's items from their respective taxable years ending December 31, 2020, are taken into account. Therefore, X's taxable income or loss and Y's taxable income or loss, determined without regard to the section 199A(g) deduction, QPAI, and W–2 wages from their taxable years ending December 31, 2020, are aggregated with Z's taxable income or loss, QPAI, and W–2 wages from its taxable year ending June 30, 2021. The EAG's QPAI is $4,000 (X's QPAI of $8,000 + Y's QPAI of ($6,000) + Z's QPAI of $2,000). The EAG's section 199A(g) deduction is $360 (9% × $4,000). A portion of the $360 deduction is allocated to Z in proportion to its QPAI as a percentage of the QPAI of each member of the EAG that was taken into account in computing the EAG's section 199A(g) deduction. Pursuant to paragraph (c)(1) of this section, in allocating a portion of the $360 deduction to Z, Y's QPAI is treated as being $0 because Y's QPAI is negative. Z's section 199A(g) deduction for its taxable year ending June 30, 2021, is $72 ($360 × ($2,000/($8,000 + $0 + $2,000))).

(i) *Partnership owned by expanded affiliated group*—(1) *In general.* For purposes of section 199A(g)(3)(D) relating to DPGR, if all of the interests in the capital and profits of a partnership are owned by members of a single EAG at all times during the taxable year of such partnership (EAG partnership), then the EAG partnership and all members of that EAG are treated as a single taxpayer during such period.

(2) *Attribution of activities*—(*i*) *In general.* If a Specified Cooperative which is a member of an EAG (disposing member) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by an EAG partnership, all the partners of which are members of the same EAG to which the disposing member belongs at the time that the disposing member disposes of such property, then the disposing member is treated as conducting the MPGE activities previously conducted by the EAG partnership with respect to that property. The previous sentence applies only for those taxable years in which the disposing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the disposing member is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing member is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account. Likewise, if an EAG partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by a member (or members) of the same EAG (the producing member) to which all the partners of the EAG partnership belong at the time that the EAG partnership disposes of such property, then the EAG partnership is treated as conducting the MPGE activities previously conducted by the producing member with respect to that property. The previous sentence applies only for those taxable years in which the producing member is a member of the EAG of which all the partners of the EAG partnership are members for the entire taxable year of the EAG partnership. With respect to a lease, rental, or license, the EAG partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts derived from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the EAG partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(*ii*) *Attribution between expanded affiliated group partnerships.* If an EAG partnership (disposing partnership) derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of property that was MPGE by another EAG partnership (producing partnership), then the disposing partnership is treated as conducting the MPGE activities previously conducted by the producing partnership with respect to that property, provided that each of these partnerships (the producing partnership and the disposing partnership) is owned for its entire taxable year in which the disposing partnership disposes of such property by members of the same EAG. With respect to a lease, rental, or license, the disposing partnership is treated as having disposed of the property on the date or dates on which it takes into account its gross receipts from the lease, rental, or license under its method of accounting. With respect to a sale, exchange, or other disposition, the disposing partnership is treated as having disposed of the property on the date it ceases to own the property for Federal income tax purposes, even if no gain or loss is taken into account.

(j) *Applicability date.* The provisions of this section apply to taxable years beginning after January 19, 2021. Taxpayers, however, may choose to apply the rules of §§1.199A–7 through 1.199A–12 for taxable years beginning on or before that date, provided the taxpayers apply the rules in their entirety and in a consistent manner.

[T.D. 9947, 86 FR 5569, Jan. 19, 2021, as amended by 87 FR 68900, Nov. 17, 2022]

ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS

§ 1.211–1 Allowance of deductions.

In computing taxable income under section 63(a), the deductions provided by sections 212, 213, 214, 215, 216, and 217 shall be allowed subject to the exceptions provided in Part IX, Subchapter B, Chapter 1 of the Code (section 261 and following, relating to items not deductible).

[T.D. 6796, 30 FR 1037, Feb. 2, 1965]

§ 1.212–1 Nontrade or nonbusiness expenses.

(a) An expense may be deducted under section 212 only if:

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term *income* for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

(c) In the case of taxable years beginning before January 1, 1970, expenses of carrying on transactions which do not constitute a trade or business of the taxpayer and are not carried on for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income, but which are carried on primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses. The question whether or not a transaction is carried on primarily for the production of income or for the management, conservation, or maintenance of property held for the production or collection of income, rather than primarily as a sport, hobby, or recreation, is not to be determined solely from the intention of the taxpayer but rather from all the circumstances of the case. For example, consideration will be given to the record of prior gain or loss of the taxpayer in the activity, the relation between the type of activity and the principal occupation of the taxpayer, and the uses to which the property or what it produces is put by the taxpayer. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

(d) Expenses, to be deductible under section 212, must be ''ordinary and necessary''. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

(e) A deduction under section 212 is subject to the restrictions and limitations in part IX (section 261 and following), subchapter B, chapter 1 of the Code, relating to items not deductible. Thus, no deduction is allowable under section 212 for any amount allocable to the production or collection of one or more classes of income which are not includible in gross income, or for any amount allocable to the management, conservation, or maintenance of property held for the production of income which is not included in gross income. See section 265. Nor does section 212 allow the deduction of any expenses which are disallowed by any of the provisions of subtitle A of the Code, even though such expenses may be paid or incurred for one of the purposes specified in section 212.

(f) Among expenditures not allowable as deductions under section 212 are the following: Commuter's expenses; expenses of taking special courses or training; expenses for improving personal appearance; the cost of rental of a safe-deposit box for storing jewelry and other personal effects; expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, campaign expenses of a candidate for public office, bar examination fees and other expenses paid or incurred in securing admission to the bar, and corresponding fees and expenses paid or incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions. See, however, section 162 and the regulations thereunder.

(g) Fees for services of investment counsel, custodial fees, clerical help, office rent, and similar expenses paid or incurred by a taxpayer in connection with investments held by him are deductible under section 212 only if (1) they are paid or incurred by the taxpayer for the production or collection of income or for the management, conservation, or maintenance of investments held by him for the production of income; and (2) they are ordinary and necessary under all the circumstances, having regard to the type of investment and to the relation of the taxpayer to such investment.

(h) Ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held for use as a residence by the taxpayer are not deductible. However, ordinary and necessary expenses paid or incurred in connection with the management, conservation, or maintenance of property held by the taxpayer as rental property are deductible even though such property was formerly held by the taxpayer for use as a home.

(i) Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212, notwithstanding that the estate or trust is not engaged in a trade or business, except to the extent that such expenses are allocable to the production or collection of tax-exempt income. But see section 642 (g) and the regulations thereunder for disallowance of such deductions to an estate where such items are allowed as a deduction under section 2053 or 2054 in computing the net estate subject to the estate tax.

(j) Reasonable amounts paid or incurred for the services of a guardian or committee for a ward or minor, and other expenses of guardians and committees which are ordinary and necessary, in connection with the production or collection of income inuring to the ward or minor, or in connection with the management, conservation, or maintenance of property, held for the production of income, belonging to the ward or minor, are deductible.

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

(l) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

(m) An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability.

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under section 212 will not be disallowed simply because the taxpayer was entitled under Subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in Subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

(o) The provisions of section 212 are not intended in any way to disallow expenses which would otherwise be allowable under section 162 and the regulations thereunder. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof.

(p) *Frustration of public policy*. The deduction of a payment will be disallowed under section 212 if the payment is of a type for which a deduction would be disallowed under section 162(c), (f), or (g) and the regulations thereunder in the case of a business expense.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 12, 1960, as amended by T.D. 7198, 37 FR 13685, July 13, 1972; T.D. 7345, 40 FR 7439, Feb. 20, 1975]

§ 1.213–1 Medical, dental, etc., expenses.

(a) *Allowance of deduction*. (1) Section 213 permits a deduction of payments for certain medical expenses (including expenses for medicine and drugs). Except as provided in paragraph (d) of this section (relating to special rule for decedents) a deduction is allowable only to individuals and only with respect to medical expenses actually paid during the taxable year, regardless of when the incident or event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. Thus, if the medical expenses are incurred but not paid during the taxable year, no deduction for such expenses shall be allowed for such year.

(2) Except as provided in subparagraphs (4)(i) and (5)(i) of this paragraph, only such medical expenses (including the allowable expenses for medicine and drugs) are deductible as exceed 3 percent of the adjusted gross income for the taxable year. For taxable years beginning after December 31, 1966, the amounts paid during the taxable year for insurance that constitute expenses paid for medical care shall, for purposes of computing total medical expenses, be reduced by the amount determined under subparagraph (5)(i) of this paragraph. For the amounts paid during the taxable year for medicine and drugs which may be taken into account in computing total medical expenses, see paragraph (b) of this section. For the maximum deduction allowable under section 213 in the case of certain taxable years, see paragraph (c) of this section. As to what constitutes ''adjusted gross income'', see section 62 and the regulations thereunder.

(3)(i) For medical expenses paid (including expenses paid for medicine and drugs) to be deductible, they must be for medical care of the taxpayer, his spouse, or a dependent of the taxpayer and not be compensated for by insurance or otherwise. Expenses paid for the medical care of a dependent, as defined in section 152 and the regulations thereunder, are deductible under this section even though the dependent has gross income equal to or in excess of the amount determined pursuant to §1.151–2 applicable to the calendar year in which the taxable year of the taxpayer begins. Where such expenses are paid by two or more persons and the conditions of section 152(c) and the regulations thereunder are met, the medical expenses are deductible only by the person designated in the multiple support agreement filed by such persons and such deduction is limited to the amount of medical expenses paid by such person.

(ii) An amount excluded from gross income under section 105 (c) or (d) (relating to amounts received under accident and health plans) and the regulations thereunder shall not constitute compensation for expenses paid for medical care. Exclusion of such amounts from gross income will not affect the treatment of expenses paid for medical care.

(iii) The application of the rule allowing a deduction for medical expenses to the extent not compensated for by insurance or otherwise may be illustrated by the following example in which it is assumed that neither the taxpayer nor his wife has attained the age of 65:

Example. Taxpayer H, married to W and having one dependent child, had adjusted gross income for 1956 of $3,000. During 1956 he paid $300 for medical care, of which $100 was for treatment of his dependent child and $200 for an operation on W which was performed in September 1955. In 1956 he received a payment of $50 for health insurance to cover a portion of the cost of W's operation performed during 1955. The deduction allowable under section 213 for the calendar year 1956, provided the taxpayer itemizes his deductions and does not compute his tax under section 3 by use of the tax table, is $160, computed as follows:

Payments in 1956 for medical care	$300
Less: Amount of insurance received in 1956	50
Payments in 1956 for medical care not compensated for during 1956	250
Less: 3 percent of $3,000 (adjusted gross income)	90
Excess, allowable as a deduction for 1956	160

(4)(i) For taxable years beginning before January 1, 1967, where either the taxpayer or his spouse has attained the age of 65 before the close of the taxable year, the 3-percent limitation on the deduction for medical expenses does not apply with respect to expenses for medical care of the taxpayer or his spouse. Moreover, for taxable years beginning after December 31, 1959, and before January 1, 1967, the 3-percent limitation on the deduction for medical expenses does not apply to amounts paid for the medical care of a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or his spouse and who has attained the age of 65 before the close of the taxpayer's taxable year. For taxable years beginning before January 1, 1964, and for taxable years beginning after December 31, 1966, all amounts paid by the taxpayer for medicine and drugs are subject to the 1-percent limitation provided by section 213(b). For taxable years beginning after December 31, 1963, and before

January 1, 1967, the 1-percent limitation provided by section 213(b) does not apply, under certain circumstances, to amounts paid by the taxpayer for medicine and drugs for the taxpayer and his spouse or for a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or of his spouse. (For additional provisions relating to the 1-percent limitation with respect to medicine and drugs, see paragraph (b) of this section.) For taxable years beginning before January 1, 1967, whether or not the 3-percent or 1-percent limitation applies, the total medical expenses deductible under section 213 are subject to the limitations described in section 213(c) and paragraph (c) of this section and, where applicable, to the limitations described in section 213(g) and §1.213–2.

(ii) The age of a taxpayer shall be determined as of the last day of his taxable year. In the event of the taxpayer's death, his taxable year shall end as of the date of his death. The age of a taxpayer's spouse shall be determined as of the last day of the taxpayer's taxable year, except that, if the spouse dies within such taxable year, her age shall be determined as of the date of her death. Likewise, the age of the taxpayer's dependent who is the mother or father of the taxpayer or of his spouse shall be determined as of the last day of the taxpayer's taxable year but not later than the date of death of such dependent.

(iii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. Taxpayer A, who attained the age of 65 on February 22, 1956, makes his return on the basis of the calendar year. During the year 1956, A had adjusted gross income of $8,000, and paid the following medical bills: (*a*) $560 (7 percent of adjusted gross income) for the medical care of himself and his spouse, and (*b*) $160 (2 percent of adjusted gross income) for the medical care of his dependent son. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for 1956 is $560, the full amount of the medical expenses for the taxpayer and his spouse. No deduction is allowable for the amount of $160 paid for medical care of the dependent son since the amount of such payment (determined without regard to the payments for the care of the taxpayer and his spouse) does not exceed 3 percent of adjusted gross income.

Example 2. H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on August 15, 1956. The adjusted gross income of H and W in 1956 was $40,000 and they paid in such year the following amounts for medical care: (*a*) $3,000 for the medical care of H; (*b*) $2,000 for the medical care of W; and (*c*) $3,000 for the medical care of the dependent child. No part of these payments was for medicine and drugs nor compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1956 is $6,800 computed as follows:

Payments for medical care of H and W in 1956		$5,000
Payments for medical care of the dependent in 1956	$3,000	
Less: 3 percent of $40,000 (adjusted gross income)	1,200	
		1,800
Allowable deduction for 1956		6,800

Example 3. D and his wife, E, made a joint income tax return for the calendar year 1962, and reported adjusted gross income of $30,000. On December 13, 1962, D attained the age of 65. During the year 1962, D's father, F, who was 87 years of age, received over half of his support from, and was a dependent (as defined in section 152) of, D. However, D could not claim an exemption under section 151 for F because F had gross income from rents in 1962 of $800. D paid the following medical expenses in 1962, none of which were compensated for by insurance or otherwise: hospital and doctor bills for D and E, $6,500; hospital and doctor bills for F, $4,850; medicine and drugs for D and E, $225, and for F, $225. Since none of the medical expenses are subject to the 3-percent limitation, the amount of medical expenses to be taken into account (before computing the maximum deduction) is $11,500, computed as follows:

Hospital and doctor bills—for D and E		$6,500
Hospital and doctor bills—for F		4,850
Medicine and drugs—for D and E	$225	
Medicine and drugs—for F	$225	
Total medicine and drugs	450	
Less: 1 percent of adjusted gross income ($30,000)	300	
Allowable expenses for medicine and drugs		$150
Total medical expenses taken into account		11,500

Since an exemption cannot be claimed for F on the 1962 return of D and E, their deduction for medical expenses (assuming that section 213(g) does not apply) is limited to $10,000 for that year ($5,000 multiplied by the two exemptions allowed for D and E under section 151(b)). If these identical facts had occurred in a taxable year beginning before January 1, 1962, the medical expense deduction for D and E would, for such taxable year, be limited to $5,000 ($2,500 multiplied by the two exemptions allowed for D and E under section 151(b)). See paragraph (c) of this section.

Example 4. Assume the same facts as in *Example 3*, except that D furnished the entire support of his father's twin sister, G, who had no gross income during 1962 and for whom D was entitled to a dependency exemption. In addition, D paid $4,800 to doctors and hospitals during 1962 for the medical care of G. No part of the $4,800 was for medicine and drugs, and no amount was compensated for by insurance or otherwise. For purposes of the maximum limitation under section 213(c), the maximum deduction for medical expenses on the 1962 return of D and E is limited to $15,000 ($5,000 multiplied by 3, the number of exemptions allowed under section 151, exclusive of the exemptions for old age or blindness). If these identical facts had occurred in a taxable year beginning before January 1, 1962, the medical expense deduction for D and E would, for such taxable year, be limited to $7,500 ($2,500 multiplied by the three exemptions allowed under section 151, exclusive of the exemptions for old age or blindness). The medical expenses to be taken into account by D and E for 1962 and the maximum deductions allowable for such expenses are $15,400 and $15,000, respectively, computed as follows:

Medical expenses per *Example 3*		$11,500
Add: Expenses paid for G	$4,800	
Less: 3 percent of adjusted gross income ($30,000)	900	
		3,900
Total medical expenses taken into account		15,400
Maximum deduction for 1962 ($5,000 multiplied by 3 exemptions)		15,000
Medical expenses not deductible		400

Example 5. Assume that the facts set forth in *Example 3* had occurred in respect of the calendar year 1964 rather than the calendar year 1962. Since both D and his father, F, had attained the age of 65 before the close of the taxable year, the 1-percent limitation does not apply to the amounts paid for medicine and drugs for D, E, and F. Accordingly, the total medical expenses taken into account by D and E for 1964 would be $11,800 (rather than $11,500 as in *Example 3*) computed as follows:

Hospital and doctor bills—for D and E	$6,500
Hospital and doctor bills—for F	4,350
Medicine and drugs—for D and E	225
Medicine and drugs—for F	225
Total medical expenses taken into account	11,800

(5)(i) For taxable years beginning after December 31, 1966, there may be deducted without regard to the 3-percent limitation the lesser of—(a) One-half of the amounts paid during the taxable year for insurance which constitute expenses for medical care for the taxpayer, his spouse, and dependents; or (b) $150.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. H and W made a joint return for the calendar year 1967. The adjusted gross income of H and W for 1967 was $10,000 and they paid in such year $370 for medical care of which amount $350 was paid for insurance which constitutes medical care for H and W. No part of the payment was for medicine and drugs or was compensated for by insurance or otherwise. The allowable deduction under section 213 for medical expenses paid in 1967 is $150, computed as follows:

(1) Lesser of $175 (one-half of amounts paid for insurance) or $150			$150
(2) Payments for medical care	$370		
(3) Less line 1	150		
(4) Medical expenses to be taken into account under 3-percent limitation (line 2 minus line 3)		$220	
(5) Less: 3 percent of $10,000 (adjusted gross income)		300	
(6) Excess allowable as a deduction for 1967 (excess of line 4 over line 5)			0
(7) Allowable medical expense deduction for 1967 (line 1 plus line 6)			$150

(b) *Limitation with respect to medicine and drugs*—(1) *Taxable years beginning before January 1, 1964.* (i) Amounts paid during taxable years beginning before January 1, 1964, for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction. The application of this subdivision may be illustrated by the following example:

Example. The taxpayer, a single individual with no dependents, had an adjusted gross income of $6,000 for the calendar year 1956. During 1956, he paid a doctor $300 for medical services, a hospital $100 for hospital care, and also spent $100 for medicine and drugs.

These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1956 is $260, computed as follows:

Payments for medical care in 1956:

Doctor		$300
Hospital		100
Medicine and drugs	$100	
Less: 1 percent of $6,000 (adjusted gross income)	60	40
Total medical expenses taken into account		440
Less: 3 percent of $6,000 (adjusted gross income)		180
Allowable deduction for 1956		260

(ii) For taxable years beginning before January 1, 1964, the 1-percent limitation is applicable to all amounts paid by a taxpayer during the taxable year for medicine and drugs. Moreover, this limitation applies regardless of the fact that the amounts paid are for medicine and drugs for the taxpayer, his spouse, or dependent parent (the mother or father of the taxpayer or of his spouse) who has attained the age of 65 before the close of the taxable year. In a case where either a taxpayer or his spouse has attained the age of 65 and the taxpayer pays an amount in excess of 1 percent of adjusted gross income for medicine and drugs for himself, his spouse, and his dependents, it is necessary to apportion the 1 percent of adjusted gross income (the portion which is not taken into account as expenses paid for medical care) between the taxpayer and his spouse on the one hand and his dependents on the other. The part of the 1 percent allocable to the taxpayer and his spouse is an amount which bears the same ratio to 1 percent of his adjusted gross income which the amount paid for medicine and drugs for the taxpayer and his spouse bears to the total amount paid for medicine and drugs for the taxpayer, his spouse, and his dependents. The balance of the 1 percent shall be allocated to his dependents. The amount paid for medicine and drugs in excess of the allocated part of the 1 percent shall be taken into account as payments for medical care for the taxpayer and his spouse on the one hand and his dependents on the other, respectively. A similar apportionment must be made in the case of a dependent parent (65 years of age or over) of the taxpayer or his spouse. The application of this subdivision (ii) may be illustrated by the following example:

Example. H and W, who have a dependent child, made a joint return for the calendar year 1956. H became 65 years of age on September 15, 1956. The adjusted gross income of H and W for 1956 is $10,000. During the year, H and W paid the following amounts for medical care: (i) $1,000 for doctors and hospital expenses and $180 for medicine and drugs for themselves; and (ii) $500 for doctors and hospital expenses and $140 for medicine and drugs for the dependent child. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a)(2) for medical expenses paid in 1956 is $1,420, computed as follows:

H and W:			
Payments for doctors and hospital			$1,000.00
Payments for medicine and drugs		$180.00	
Less: Limitation for medicine and drugs (see computation below)		56.25	123.75
Medical expenses for H and W to be taken into account			1,123.75
Dependent:			
Payments for doctors and hospital		500.00	
Payments for medicine and drugs	$140.00		
Less: Limitation for medicine and drugs (see computation below)	43.75	96.25	
Total medical expenses		596.25	
Less: 3 percent of $10,000 (adjusted gross income)		300.00	
Medical expenses for the dependent to be taken into account			296.25
Allowable deductions for 1956			1,420.00
Payments for medicine and drugs:			
H and W			180.00
Dependent			140.00
Total payments			320.00
Less: 1 percent of $10,000 (adjusted gross income)			100.00
Payments to be taken into account			20.00
Allocation of 1-percent exclusion:			
H and W ($180 \div 320 \times \$100$)			56.25

Dependent (140 ÷ 320 × $100)			43.75
Total			100.00

(2) *Taxable years beginning after December 31, 1963.* (i) Except as otherwise provided in subdivision (ii) of this subparagraph, amounts paid during taxable years beginning after December 31, 1963, for medicine and drugs are to be taken into account in computing the allowable deduction for medical expenses paid during the taxable year only to the extent that the aggregate of such amounts exceeds 1 percent of the adjusted gross income for the taxable year. Thus, if the aggregate of the amounts paid for medicine and drugs which are subject to the 1-percent limitation exceeds 1 percent of adjusted gross income, the excess is added to other medical expenses for the purpose of computing the medical expense deduction.

(ii) The 1-percent limitation provided by section 213 does not apply to amounts paid by a taxpayer during a taxable year beginning after December 31, 1963, and before January 1, 1967, for medicine and drugs for the medical care of the taxpayer and his spouse if either has attained the age of 65 before the close of the taxable year. Moreover, for taxable years beginning after December 31, 1963, and before January 1, 1967, the 1-percent limitation with respect to medicine and drugs does not apply to amounts paid for the medical care of a dependent (as defined in sec. 152) who is the mother or father of the taxpayer or of his spouse and who has attained the age of 65 before the close of the taxpayer's taxable year. Amounts paid for medicine and drugs which are not subject to the limitation on medicine and drugs are added to other medical expenses of a taxpayer and his spouse or the dependent (as the case may be) for the purpose of computing the medical expense deduction.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. H and W, who have a dependent child, C, were both under 65 years of age at the close of the calendar year 1964 and made a joint return for that calendar year. During the year 1964, H's mother, M, attained the age of 65, and was a dependent (as defined in section 152) of H. The adjusted gross income of H and W in 1964 was $12,000. During 1964 H and W paid the following amounts for medical care: (i) $600 for doctors and hospital expenses and $120 for medicine and drugs for themselves; (ii) $350 for doctors and hospital expenses and $60 for medicine and drugs for C; and (iii) $400 for doctors and hospital expenses and $100 for medicine and drugs for M. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a) (1) for medical expenses paid in 1964 is $1,150, computed as follows:

H, W, and C:			
Payments for doctors and hospital		$950	
Payments for medicine and drugs	$180		
Less: 1 percent of $12,000 (adjusted gross income)	120	60	
Total medical expenses		1,010	
Less: 3 percent of $12,000 (adjusted gross income)		360	
Medical expenses of H, W, and C to be taken into account			$650
M:			
Payments for doctors and hospitals		400	
Payments for medicine and drugs		100	
Medical expenses of M to be taken into account			500
Allowable deduction for 1964			1,150

Example 2. H and W, who have a dependent child, C, made a joint return for the calendar year 1964, and reported adjusted gross income of $12,000. H became 65 years of age on January 23, 1964. F, the 87 year old father of W, was a dependent of H. During 1964, H and W paid the following amounts for medical care: (i) $400 for doctors and hospital expenses and $75 for medicine and drugs for H; (ii) $200 for doctors and hospital expenses and $100 for medicine and drugs for W; (iii) $200 for doctors and hospital expenses and $175 for medicine and drugs for C; and (iv) $700 for doctors and hospital expenses and $150 for medicine and drugs for F. These payments were not compensated for by insurance or otherwise. The deduction allowable under section 213(a) (2) for medical expenses paid in 1964 is $1,625, computed as follows:

H and W:		
Payments for doctors and hospital	$600	
Payments for medicine and drugs	175	
Medical expenses for H and W to be taken into account		$775
F:		
Payments for doctors and hospital	700	
Payments for medicine and drugs	150	

Medical expenses for F to be taken into account			850
C:			
Payments for doctors and hospital		200	
Payments for medicine and drugs	$175		
Less: 1 percent of $12,000 (adjusted gross income)	120	55	
Total medical expenses		255	
Less: 3 percent of $12,000 (adjusted gross income)		360	
Medical expenses for C to be taken into account			0
Allowable deduction for 1964.			1,625

Example 3. Assume the same facts as example (2) except that the calendar year of the return is 1967 and the amounts paid for medical care were paid during 1967. The deduction allowable under section 213(a) for medical expenses paid in 1967 is $1,520, computed as follows:

Payments for doctors and hospitals:				
H	$400			
W	200			
C	200			
F	700			
			$1,500	
Payments for medicine and drugs:				
H	75			
W	100			
C	175			
F	150			
		$500		
Less: 1 percent of $12,000 (adjusted gross income)		120	380	
Medical expenses to be taken into account				$1,880
Less: 3 percent of $12,000 (adjusted gross income)				360
Allowable medical expense deduction for 1967				1,520

(3) *Definition of medicine and drugs.* For definition of medicine and drugs, see paragraph (e) (2) of this section.

(c) *Maximum limitations.* (1) For taxable years beginning after December 31, 1966, there shall be no maximum limitation on the amount of the deduction allowable for payment of medical expenses.

(2) Except as provided in section 213(g) and §1.213–2 (relating to maximum limitations with respect to certain aged and disabled individuals for taxable years beginning before January 1, 1967), for taxable years beginning after December 31, 1961, and before January 1, 1967, the maximum deduction allowable for medical expenses paid in any one taxable year is the lesser of:

(i) $5,000 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151(c) for a taxpayer or spouse attaining the age of 65, or section 151(d) for a taxpayer who is blind or a spouse who is blind);

(ii) $10,000, if the taxpayer is single, not the head of a household (as defined in section 1(b) (2)) and not a surviving spouse (as defined in section 2(b)), or is married and files a separate return; or

(iii) $20,000 if the taxpayer is married and files a joint return with his spouse under section 6013, or is the head of a household (as defined in section 1(b) (2)), or a surviving spouse (as defined in section 2(b)).

(3) The application of subparagraph (2) of this paragraph may be illustrated by the following example:

Example. H and W made a joint return for the calendar year 1962 and were allowed five exemptions (exclusive of exemptions under sec. 151 (c) and (d)), one for each taxpayer and three for their dependents. The adjusted gross income of H and W in 1962 was $80,000. They paid during such year $26,000 for medical care, no part of which is compensated for by insurance or otherwise. The deduction allowable under section 213 for the calendar year 1962 is $20,000, computed as follows:

Payments for medical care in 1962	$26,000
Less: 3 percent of $80,000 (adjusted gross income)	2,400
Excess of medical expenses in 1962 over 3 percent of adjusted gross income	23,600
Allowable deduction for 1962 ($5,000 multiplied by five exemptions allowed under sec. 151 (b) and (e) but not in excess of $20,000)	20,000

(4) Except as provided in section 213(g) and §1.213–2 (relating to certain aged and disabled individuals), for taxable years beginning before January 1, 1962, the maximum deduction allowable for medical expenses paid in any 1 taxable year is the lesser of:

(i) $2,500 multiplied by the number of exemptions allowed under section 151 (exclusive of exemptions allowed under section 151(c) for a taxpayer or spouse attaining the age of 65, or section 151(d) for a taxpayer who is blind or a spouse who is blind);

(ii) $5,000, if the taxpayer is single, not the head of a household (as defined in section 1(b) (2)) and not a surviving spouse (as defined in section 2(b)) or is married and files a separate return; or

(iii) $10,000, if the taxpayer is married and files a joint return with his spouse under section 6013, or is head of a household (as defined in section 1(b)(2)), or a surviving spouse (as defined in section 2(b)).

(5) For the maximum deduction allowable for taxable years beginning before January 1, 1967, if the taxpayer or his spouse is age 65 or over and is disabled, see §1.213–2.

(d) *Special rule for decedents.* (1) For the purpose of section 213 (a), expenses for medical care of the taxpayer which are paid out of his estate during the 1-year period beginning with the day after the date of his death shall be treated as paid by the taxpayer at the time the medical services were rendered. However, no credit or refund of tax shall be allowed for any taxable year for which the statutory period for filing a claim has expired. See section 6511 and the regulations thereunder.

(2) The rule prescribed in subparagraph (1) of this paragraph shall not apply where the amount so paid is allowable under section 2053 as a deduction in computing the taxable estate of the decedent unless there is filed in duplicate (i) a statement that such amount has not been allowed as a deduction under section 2053 in computing the taxable estate of the decedent and (ii) a waiver of the right to have such amount allowed at any time as a deduction under section 2053. The statement and waiver shall be filed with or for association with the return, amended return, or claim for credit or refund for the decedent for any taxable year for which such an amount is claimed as a deduction.

(e) *Definitions*—(1) *General.* (i) The term *medical care* includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for ''medical care'' shall include those paid for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. See subparagraph (4) of this paragraph for provisions relating to medical insurance.

(ii) Amounts paid for operations or treatments affecting any portion of the body, including obstetrical expenses and expenses of therapy or X-ray treatments, are deemed to be for the purpose of affecting any structure or function of the body and are therefore paid for medical care. Amounts expended for illegal operations or treatments are not deductible. Deductions for expenditures for medical care allowable under section 213 will be confined strictly to expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness. Thus, payments for the following are payments for medical care: hospital services, nursing services (including nurses' board where paid by the taxpayer), medical, laboratory, surgical, dental and other diagnostic and healing services, X-rays, medicine and drugs (as defined in subparagraph (2) of this paragraph, subject to the 1-percent limitation in paragraph (b) of this section), artificial teeth or limbs, and ambulance hire. However, an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.

(iii) Capital expenditures are generally not deductible for Federal income tax purposes. See section 263 and the regulations thereunder. However, an expenditure which otherwise qualifies as a medical expense under section 213 shall not be disqualified merely because it is a capital expenditure. For purposes of section 213 and this paragraph, a capital expenditure made by the taxpayer may qualify as a medical expense, if it has as its primary purpose the medical care (as defined in subdivisions (i) and (ii) of this subparagraph) of the taxpayer, his spouse, or his dependent. Thus, a capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as an expenditure for medical care, shall be deductible; for example, an expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc. Moreover, a capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care (within the meaning of this paragraph) may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property, if the particular expenditure is related directly to medical care. Such a situation could arise, for example, where a taxpayer is advised by a physician to install an elevator in his residence so that the taxpayer's wife who is afflicted with heart disease will not be required to climb stairs. If the cost of installing the elevator is $1,000 and the increase in the value of the residence is determined to be only $700, the difference of $300, which is the amount in excess of the value enhancement, is deductible as a medical expense. If, however, by reason of this expenditure, it is determined that the value of the residence has not been increased, the entire cost of installing the elevator would qualify as a medical expense. Expenditures made for the operation or maintenance of a capital asset are likewise deductible medical expenses if they have as their primary purpose the medical care (as defined in subdivisions (i) and (ii) of this subparagraph) of the taxpayer, his spouse, or his dependent. Normally, if a capital expenditure qualifies as a medical expense, expenditures for the operation or maintenance of the capital asset would also qualify provided that the medical reason for the capital expenditure still exists. The entire amount of such operation and maintenance expenditures qualifies, even if none or only a portion of the original cost of the capital asset itself qualified.

(iv) Expenses paid for transportation primarily for and essential to the rendition of the medical care are expenses paid for medical care. However, an amount allowable as a deduction for ''transportation primarily for and essential to medical care'' shall not include the cost of any meals and lodging while away from home receiving medical treatment. For example, if a doctor prescribes that a taxpayer go to a warm climate in order to alleviate a specific chronic ailment, the cost of meals and lodging while there would not be deductible. On the other hand, if the travel is undertaken merely for the general improvement of a taxpayer's health, neither the cost of transportation nor the cost of meals and lodging would be deductible. If a doctor prescribes an operation or other medical care, and the taxpayer chooses for purely personal considerations to travel to another locality (such as a resort area) for the operation or the other medical care, neither the cost of transportation nor the cost of meals and lodging (except where paid as part of a hospital bill) is deductible.

(v) The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined in this subdivision shall be considered an institution for purposes of the rules provided herein. In general, the following rules will be applied:

(*a*) Where an individual is in an institution because his condition is such that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care. For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term *medical care*.

(*b*) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for purposes of this section. For example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

(*c*) It is immaterial for purposes of this subdivision whether the medical care is furnished in a Federal or State institution or in a private institution.

(vi) See section 262 and the regulations thereunder for disallowance of deduction for personal living, and family expenses not falling within the definition of medical care.

(2) *Medicine and drugs*. The term *medicine and drugs* shall include only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs (whether or not requiring a prescription). Such term shall not include toiletries or similar preparations (such as toothpaste, shaving lotion, shaving cream, etc.) nor shall it include cosmetics (such as face creams, deodorants, hand lotions, etc., or any similar preparation used for ordinary cosmetic purposes) or sundry items. Amounts expended for items which, under this subparagraph, are excluded from the term *medicine and drugs* shall not constitute amounts expended for ''medical care''.

(3) *Status as spouse or dependent*. In the case of medical expenses for the care of a person who is the taxpayer's spouse or dependent, the deduction under section 213 is allowable if the status of such person as ''spouse'' or ''dependent'' of the taxpayer exists either at the time the medical services were rendered or at the time the expenses were paid. In determining whether such status as ''spouse'' exists, a taxpayer who is legally separated from his spouse under a decree of separate maintenance is not considered as married. Thus, payments made in June 1956 by A, for medical services rendered in 1955 to B, his wife, may be deducted by A for 1956 even though, before the payments were made, B may have died or in 1956 secured a divorce. Payments made in July 1956 by C, for medical services rendered to D in 1955 may be deducted by C for 1956 even though C and D were not married until June 1956.

(4) *Medical insurance*. (i)(*a*) For taxable years beginning after December 31, 1966, expenditures for insurance shall constitute expenses paid for medical care only to the extent that such amounts are paid for insurance covering expenses of medical care referred to in subparagraph (1) of this paragraph. In the case of an insurance contract under which amounts are payable for other than medical care (as, for example, a policy providing an indemnity for loss of income or for loss of life, limb, or sight):

(*1*) No amount shall be treated as paid for insurance covering expenses of medical care referred to in subparagraph (1) of this paragraph unless the charge for such insurance is either separately stated in the contract or furnished to the policyholder by the insurer in a separate statement,

(*2*) The amount taken into account as the amount paid for such medical insurance shall not exceed such charge, and

(*3*) No amount shall be treated as paid for such medical insurance if the amount specified in the contract (or furnished to the policyholder by the insurer in a separate statement) as the charge for such insurance is unreasonably large in relation to the total charges under the contract.

For purposes of the preceding sentence, amounts will be considered payable for other than medical care under the contract if the contract provides for the waiver of premiums upon the occurrence of an event. In determining whether a separately stated charge for insurance covering expenses of medical care is unreasonably large in relation to the total premium, the relationship of the coverages under the contract together with all of the facts and circumstances shall be considered. In determining whether a contract constitutes an ''insurance'' contract it is irrelevant whether the benefits are payable in cash or in services. For example, amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care. Premiums paid under Part B, title XVIII of the Social Security Act (42 U.S.C. 1395j–1395w), relating to supplementary medical insurance benefits for the aged, are amounts paid for insurance covering expenses of medical care. Taxes imposed by any governmental unit do not, however, constitute amounts paid for such medical insurance.

(*b*) For taxable years beginning after December 31, 1966, subject to the rules of (*a*) of this subdivision, premiums paid during a taxable year by a taxpayer under the age of 65 for insurance covering expenses of medical care for the taxpayer, his spouse, or a dependent after the taxpayer attains the age of 65 are to be treated as expenses paid during the taxable year for insurance covering expenses of medical care if the premiums for such insurance are payable (on a level payment basis) under the contract:

(*1*) For a period of 10 years or more, or

(*2*) Until the year in which the taxpayer attains the age of 65 (but in no case for a period of less than 5 years).

For purposes of this subdivision (*b*), premiums will be considered payable on a level payment basis if the total premium under the contract is payable in equal annual or more frequent installments. Thus, a total premium of $10,000 payable over a period of 10 years at $1,000 a year shall be considered payable on a level payment basis.

(ii) For taxable years beginning before January 1, 1967, expenses paid for medical care shall include amounts paid for accident or health insurance. In determining whether a contract constitutes an ''insurance'' contract it is irrelevant whether the benefits are payable in cash or in services. For example, amounts paid for hospitalization insurance, for membership in an association furnishing cooperative or so-called free-choice medical service, or for group hospitalization and clinical care are expenses paid for medical care.

(f) *Exclusion of amounts allowed for care of certain dependents.* Amounts taken into account under section 44A in computing a credit for the care of certain dependents shall not be treated as expenses paid for medical care.

(g) *Reimbursement for expenses paid in prior years.* (1) Where reimbursement, from insurance or otherwise, for medical expenses is received in a taxable year subsequent to a year in which a deduction was claimed on account of such expenses, the reimbursement must be included in gross income in such subsequent year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year. See section 104, relating to compensation for injuries or sickness, and section 105(b), relating to amounts expended for medical care, and the regulations thereunder, with regard to amounts in excess of or not attributable to deductions allowed.

(2) If no medical expense deduction was taken in an earlier year, for example, if the standard deduction under section 141 was taken for the earlier year, the reimbursement received in the taxable year for the medical expense of the earlier year is not includible in gross income.

(3) In order to allow the same aggregate medical expense deductions as if

the reimbursement received in a subsequent year or years had been received in the year in which the payments for medical care were made, the following rules shall be followed:

(i) If the amount of the reimbursement is equal to or less than the amount which was deducted in a prior year, the entire amount of the reimbursement shall be considered attributable to the deduction taken in such prior year (and hence includible in gross income); or

(ii) If the amount of the reimbursement received in such subsequent year or years is greater than the amount which was deducted for the prior year, that portion of the reimbursement received which is equal in amount to the deduction taken in the prior year shall be considered as attributable to such deduction (and hence includible in gross income); but

(iii) If the deduction for the prior year would have been greater but for the limitations on the maximum amount of such deduction provided by section 213 (c), then the amount of the reimbursement attributable to such deduction (and hence includible in gross income) shall be the amount of the reimbursement received in a subsequent year or years reduced by the amount disallowed as a deduction because of the maximum limitation, but not in excess of the deduction allowed for the previous year.

(4) The application of subparagraphs (1), (2), and (3) of this paragraph may be illustrated by the following examples. *Examples 1* and *2* reflect the maximum limitation on the medical expense deduction applicable to taxable years beginning after December 31, 1961. *Examples 3* and *4* reflect the maximum limitation on the medical expense deduction applicable to taxable years beginning prior to January 1, 1962. For explanation of such maximum medical expense limitations, see paragraph (c) of this section.

Example 1. Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of $35,000 for the calendar year 1962. During 1962 he paid $16,000 for medical care. A received no reimbursement for such medical expenses in 1962, but in 1963 he received $6,000 upon an insurance policy covering the medical expenses which he paid in 1962. A was allowed a deduction of $10,000 (the maximum) from his adjusted gross income for 1962. The amount which A must include in his gross income for 1963 is $1,050, and the amount to be excluded from gross income for 1963 is $4,950, computed as follows:

Payments for medical care in 1962 (not reimbursed in 1962)	$16,000
Less: 3 percent of $35,000 (adjusted gross income)	1,050
Excess of medical expenses not reimbursed in 1962 over 3 percent of adjusted gross income	10,000
Allowable deduction for 1962	10,000
Amount by which the medical deductions for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	4,950
Reimbursement received in 1963	$6,000
Less: Amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitation on the maximum amount provided by section 213	4,950
Reimbursement received in 1963 reduced by the amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	1,050
Amount attributed to medical deduction taken for 1962	1,050
Amount to be included in gross income for 1963	1,050
Amount to be excluded from gross income for 1963 ($6,000 less $1,050)	4,950

Example 2. Assuming that A, in example (1), received $15,000 in 1963 as reimbursement for the medical expenses which he paid in 1962, the amount which A must include in his gross income for 1963 is $10,000, and the amount to be excluded from gross income for 1963 is $5,000, computed as follows:

Reimbursement received in 1963	$15,000
Less: Amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	4,950
Reimbursement received in 1963 reduced by the amount by which the medical deduction for 1962 would have been greater than $10,000 but for the limitations on the maximum amount provided by section 213	10,050
Deduction allowable for 1962	10,000
Amount of reimbursement received in 1963 to be included in gross income for 1963 as attributable to deduction allowable for 1962	10,000
Amount to be excluded from gross income for 1963 ($15,000 less $10,000)	5,000

Example 3. Taxpayer A, a single individual (not the head of a household and not a surviving spouse) with one dependent, is entitled to two exemptions under the provisions of section 151. He had an adjusted gross income of $35,000 for the calendar year 1956. During 1956 he paid $9,000 for medical care. A received no reimbursement for such medical

expenses in 1956, but in 1957 he received $6,000 upon an insurance policy covering the medical expenses which he paid in 1956. A was allowed a deduction of $5,000 (the maximum) from his adjusted gross income for 1956. The amount which A must include in his gross income for 1957 is $3,050 and the amount to be excluded from gross income for 1957 is $2,950, computed as follows:

Payments for medical care in 1956 (not reimbursed in 1956)	$9,000
Less: 3 percent of $35,000 (adjusted gross income)	1,050
Excess of medical expenses not reimbursed in 1956 over 3 percent of adjusted gross income	7,950
Allowable deduction for 1956	5,000
Amount by which the medical deductions for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957	6,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	8,050
Amount attributed to medical deduction taken for 1956	3,050
Amount to be included in gross income for 1957	3,050
Amount to be excluded from gross income for 1957 ($6,000 less $3,050)	2,950

Example 4. Assuming that A, in example (3), received $8,000 in 1957 as reimbursement for the medical expenses which he paid in 1956, the amount which A must include in his gross income for 1957 is $5,000 and the amount to be excluded from gross income for 1957 is $3,000 computed as follows:

Reimbursement received in 1957	$8,000
Less: Amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	2,950
Reimbursement received in 1957 reduced by the amount by which the medical deduction for 1956 would have been greater than $5,000 but for the limitations on the maximum amount provided by section 213	5,050
Deduction allowable for 1956	5,000
Amount of reimbursement received in 1957 to be included in gross income for 1957 as attributable to deduction allowable for 1956	5,000
Amount to be excluded from gross income for 1957 ($8,000 less $5,000)	3,000

(h) *Substantiation of deductions*. In connection with claims for deductions under section 213, the taxpayer shall furnish the name and address of each person to whom payment for medical expenses was made and the amount and date of the payment thereof in each case. If payment was made in kind, such fact shall be so reflected. Claims for deductions must be substantiated, when requested by the district director, by a statement or itemized invoice from the individual or entity to which payment for medical expenses was made showing the nature of the service rendered, and to or for whom rendered; the nature of any other item of expense and for whom incurred and for what specific purpose, the amount paid therefor and the date of the payment thereof; and by such other information as the district director may deem necessary.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.213–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov*.

§ 1.215–1 Periodic alimony, etc., payments.

(a) A deduction is allowable under section 215 with respect to periodic payments in the nature of, or in lieu of, alimony or an allowance for support actually paid by the taxpayer during his taxable year and required to be included in the income of the payee wife or former wife, as the case may be, under section 71. As to the amounts required to be included in the income of such wife or former wife, see section 71 and the regulations thereunder. For definition of *husband* and *wife* see section 7701(a) (17).

(b) The deduction under section 215 is allowed only to the obligor spouse. It is not allowed to an estate, trust, corporation, or any other person who may pay the alimony obligation of such obligor spouse. The obligor spouse, however, is not allowed a deduction for any periodic payment includible under section 71 in the income of the wife or former wife, which payment is attributable to property transferred in discharge of his obligation and which, under section 71(d) or section 682, is not includible in his gross income.

(c) The following examples, in which both H and W file their income tax returns on the basis of a calendar year, illustrate cases in which a deduction is or is not allowed under section 215:

Example 1. Pursuant to the terms of a decree of divorce, H, in 1956, transferred securities valued at $100,000 in trust for the benefit of W, which fully discharged all his obligations to W. The periodic payments made by the trust to W are required to be included in W's income under section 71. Such payments are stated in section 71(d) not to be includible in H's income and, therefore, under section 215 are not deductible from his income.

Example 2. A decree of divorce obtained by W from H incorporated a previous agreement of H to establish a trust, the trustees of which were instructed to pay W $5,000 a year for the remainder of her life. The court retained jurisdiction to order H to provide further payments if necessary for the support of W. In 1956 the trustee paid to W $4,000 from the income of the trust and $1,000 from the corpus of the trust. Under the provisions of sections 71 and 682(b), W would include $5,000 in her income for 1956. H would not include any part of the $5,000 in his income nor take a deduction therefor. If H had paid the $1,000 to W pursuant to court order rather than allowing the trustees to pay it out of corpus, he would have been entitled to a deduction of $1,000 under the provisions of section 215.

(d) For other examples, see sections 71 and 682 and the regulations thereunder.

§ 1.215–1T Alimony, etc., payments (temporary).

Q–1 What information is required by the Internal Revenue Service when an alimony or separate maintenance payment is claimed as a deduction by a payor?

A–1 The payor spouse must include on his/her first filed return of tax (Form 1040) for the taxable year in which the payment is made the payee's social security number, which the payee is required to furnish to the payor. For penalties applicable to a payor spouse who fails to include such information on his/her return of tax or to a payee spouse who fails to furnish his/her social security number to the payor spouse, see section 6676.

(98 Stat. 798, 26 U.S.C. 1041(d)(4); 98 Stat. 802, 26 U.S.C. 152(e)(2)(A); 98 Stat. 800, 26 U.S.C. 215(c); 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7973, 49 FR 34458, Aug. 31, 1984]

§ 1.216–1 Amounts representing taxes and interest paid to cooperative housing corporation.

(a) *General rule.* A tenant-stockholder of a cooperative housing corporation may deduct from his gross income amounts paid or accrued within his taxable year to a cooperative housing corporation representing his proportionate share of:

(1) The real estate taxes allowable as a deduction to the corporation under section 164 which are paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on the houses (or apartment building) and the land on which the houses (or apartment building) are situated, or

(2) The interest allowable as a deduction to the corporation under section 163 which is paid or incurred by the corporation before the close of the taxable year of the tenant-stockholder on its indebtedness contracted in the acquisition, construction, alteration, rehabilitation, or maintenance of the houses (or apartment building), or in the acquisition of the land on which the houses (or apartment building) are situated.

(b) *Limitation.* The deduction allowable under section 216 shall not exceed the amount of the tenant-stockholder's proportionate share of the taxes and interest described therein. If a tenant-stockholder pays or incurs only a part of his proportionate share of such taxes and interest to the corporation, only the amount so paid or incurred which represents taxes and interest is allowable as a deduction under section 216. If a tenant-stockholder pays an amount, or incurs an obligation for an amount, to the corporation on account of such taxes and interest and other items, such as maintenance, overhead expenses, and reduction of mortgage indebtedness, the amount representing such taxes and interest is an amount which bears the same ratio to the total amount of the tenant-stockholder's payment or liability, as the case may be, as the total amount of the tenant-stockholder's proportionate share of such taxes and interest bears to the total amount of the tenant-stockholder's proportionate share of the taxes, interest, and other items on account of which such payment is made or liability incurred. No deduction is allowable under section 216 for that part of amounts representing the taxes or interest described in that section which are deductible by a tenant-stockholder under any other provision of the Code.

(c) *Disallowance of deduction for certain payments to the corporation.* For taxable years beginning after December 31, 1986, no deduction shall be allowed to a stockholder during any taxable year for any amount paid or accrued to a cooperative housing corporation (in excess of the stockholder's proportionate share of the items described in paragraphs (a) (1) and (2) of this section) which is allocable to amounts that are paid or incurred at any time by the cooperative housing corporation and which is chargeable to the corporation's capital account. Examples of expenditures chargeable to the corporation's capital account include the cost of paving a community parking lot, the purchase of a new boiler or roof, and the payment of the principal of the corporation's building mortgage. The adjusted basis of the stockholder's stock in such corporation shall be increased by the amount of such disallowance. This paragraph may be illustrated by the following example:

Example. The X corporation is a cooperative housing corporation within the meaning of section 216. In 1988 X uses $275,000 that it received from its shareholders in such year to purchase and place in service a new boiler. The $275,000 will be chargeable to the corporation's capital account. A owns 10% of the shares of X and uses in a trade or business the dwelling unit appurtenant to A's shares and was responsible for paying 10% of the cost of the boiler. A is thus responsible for $27,500 of the cost of the boiler, which amount A will not be able to deduct currently. A will, however, add the $27,500 to A's basis for A's shares in X.

(d) *Tenant-stockholder's proportionate share*—(1) *General rule.* The tenant-stockholder's proportionate share is that proportion which the stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. For taxable years beginning after December 31, 1969, if the cooperative housing corporation had issued stock to a governmental unit, as defined in paragraph (g) of this section, then in determining the total outstanding stock of the corporation, the governmental unit shall be deemed to hold the number of shares that it would have held, with respect to the apartments or houses it is entitled to occupy, if it had been a tenant-stockholder. That is, the number of shares the governmental unit is deemed to hold is determined in the same manner as if stock had been issued to it as a tenant-stockholder. For example, if a cooperative housing corporation requires each tenant-stockholder to buy one share of stock for each one thousand dollars of value of the apartment he is entitled to occupy, a governmental unit shall be deemed to hold one share of stock for each one thousand dollars of value of the apartments it is entitled to occupy, regardless of the number of shares formally issued to it.

(2) *Special rule*—(i) *In general.* For taxable years beginning after December 31, 1986, if a cooperative housing corporation allocates to each tenant-stockholder a portion of the real estate taxes or interest (or both) that reasonably reflects the cost to the corporation of the taxes or interest attributable to each tenant-stockholder's dwelling unit (and the unit's share of the common areas), the cooperative housing corporation may elect to treat the amounts so allocated as the tenant-stockholders' proportionate shares.

(ii) *Time and manner of making election.* The election referred to in paragraph (d)(2)(i) of this section is effective only if, by January 31 of the year following the first calendar year that includes any period to which the election applies, the cooperative housing corporation furnishes to each person that is a tenant-stockholder during that period a written statement showing the amount of real estate taxes or interest (or both) allocated to the tenant-stockholder with respect to the tenant-stockholder's dwelling unit or units and share of common areas for that period. The election must be made by attaching a statement to the corporation's timely filed tax return (taking extensions into account) for the first taxable year for which the election is to be effective. The statement must contain the name, address, and taxpayer identification number of the cooperative housing corporation, identify the election as an election under section 216(b)(3)(B)(ii) of the Code, indicate whether the election is being made with respect to the allocation of real estate taxes or interest (or both), and include a description of the method of allocation being elected. The election applies for the taxable year and succeeding taxable years. It is revocable only with the consent of the Commissioner and will be binding on all tenant-stockholders.

(iii) *Reasonable allocation.* It is reasonable to allocate to each tenant-stockholder a portion of the real estate taxes or interest (or both) that bears the same ratio to the cooperative housing corporation's total interest or real estate taxes as the fair market value of each dwelling unit (including the unit's share of the common areas) bears to the fair market value of all the dwelling units with respect to which stock is outstanding (including stock held by the corporation) at the time of allocation. If real estate taxes are separately assessed on each dwelling unit by the relevant taxing authority, an allocation of real estates taxes to tenant-stockholders based on separate assessments is a reasonable allocation. If one or more of the tenant-stockholders prepays any portion of the principal of the indebtedness and gives rise to interest, an allocation of interest to those tenant-stockholders will be a reasonable allocation of interest if the allocation is reduced to reflect the reduction in the debt service attributable to the prepayment. In addition, similar kinds of allocations may also be reasonable, depending on the facts and circumstances.

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

Example 1. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1970, it acquires a building containing 40 category A apartments and 25 category B apartments, for $750,000. The value of each category A apartment is $12,500, and of each category B apartment is $10,000. X values each share of stock issued with respect to the category A apartments at $125, and sells 4,000 shares of its stock, along with the right to occupy the 40 category A apartments, to 40 tenant-stockholders for $500,000. X also sells 1,000 shares of nonvoting stock to G, a State housing authority qualifying as a governmental unit under paragraph (f) of this section, for $250,000. The purchase of this stock gives G the right to occupy all the category B apartments. G is deemed to hold the number of shares that it would have held if it had been a tenant-stockholder. G is therefore deemed to own 2,000 shares of stock of X. All stockholders are required to pay a specified part of the corporation's expenses. F, one of the tenant-stockholders, purchased 100 shares of the category A stock for $12,500 in order to obtain a right to occupy a category A apartment. Since there are 6,000 total shares deemed outstanding, F's proportionate share is 1/60 (100/6,000).

Example 2. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1960 it acquired a housing development containing 100 detached houses, each house having the same value. X issued one share of stock to each of 100 tenant-stockholders, each share carrying the right to occupy one of the houses. In 1971 X redeemed 40 of its 100 shares. It then sold to G, a municipal housing authority qualifying as a governmental unit under paragraph (f) of this section, 1,000 shares of preferred stock and the right to occupy the 40 houses with respect to which the stock had been redeemed. X sold the preferred stock to G for an amount equal to the cost of redeeming the 40 shares. G also agreed to pay 40 percent of X's expenses. For purposes of determining the total stock which X has outstanding, G is deemed to hold 40 shares of X.

Example 3. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires for $1,000,000 a building containing 10 category A apartments, 10 category B apartments, and 10 category C apartments. The value of each category A apartment is $20,000, of each category B apartment is $30,000 and of each category C apartment is $50,000. X issues 1 share of stock to each of the 30 tenant-stockholders, each share carrying the right to occupy one of the apartments. X allocates the real estate taxes and interest to the tenant-stockholders on the basis of the fair market value of their respective apartments. Since the total fair market value of all of the apartments is $1,000,000, the allocation of taxes and interest to each tenant-stockholder that has the right to occupy a category A apartment is 2/100 ($20,000/$1,000,000). Similarly, the allocation of taxes and interest to each tenant-stockholder who has a right to occupy a category B apartment is 3/100 ($30,000/$1,000,000) and of a category C apartment is 5/100 ($50,000/$1,000,000). X may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of real estate taxes and interest.

Example 4. The Y Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a housing development containing 5 detached houses for $1,500,000, incurring an indebtedness of $1,000,000 for the purchase of the property. Each house is valued at $300,000, although the shares appurtenant to those houses have been sold to tenant-stockholders for $100,000. Y issues one share of stock to each of the five tenant-stockholders, each share carrying the right to occupy one of the houses. A, a tenant-stockholder, prepays all of the corporation's indebtedness allocable to A's house. The periodic charges payable to Y by A are reduced commensurately with the reduction in Y's debt service. Because no part of the indebtedness remains outstanding with respect to A's house, A's share of the interest expense is $0. The other four tenant-stockholders do not prepay their share of the indebtedness. Accordingly, ¼ of the interest is allocated to each of the tenant-stockholders other than A. Y may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of interest.

Example 5. The Z Corporation is a cooperative housing corporation within the meaning of section 216. In 1987, it acquires a building containing 10 apartments. One of the apartments is occupied by a senior citizen. Under local law, a senior citizen who owns and occupies a residential apartment is entitled to a $500 reduction in local property taxes assessed upon the apartment. As a result, Z corporation is eligible under local law for a reduction in local property taxes assessed upon the building. Z's real estate tax assessment for the year would have been $10,000, however, with the senior citizen reduction, the assessment is $9,500. The proprietary lease provides for a reduced maintenance fee to the senior citizen tenant-stockholder in accordance with the real estate tax reduction. Accordingly, each apartment owner is assessed $1,000 for local real estate taxes, except the senior citizen tenant-stockholder, who is assessed $500. Z may elect in accordance with the rules described in paragraph (d)(2) of this section to treat the amounts so allocated as each tenant-stockholder's proportionate share of taxes.

(e) *Cooperative housing corporation.* In order to qualify as a ''cooperative housing corporation'' under section 216, the requirements of subparagraphs (1) through (4) of this paragraph must be met.

(1) *One class of stock.* The corporation shall have one and only one class of stock outstanding. However, a special classification of preferred stock, in a nominal amount not exceeding $100, issued to a Federal housing agency or other governmental agency solely for the purpose of creating a security device on the mortgage indebtedness of the corporation, shall be disregarded for purposes of determining whether the corporation has one class of stock outstanding and such agency will not be considered a stockholder for purposes of section 216 and this section. Furthermore, for taxable years beginning after December 31, 1969, a special class of stock issued to a governmental unit, as defined in paragraph (g) of this section, shall also be disregarded for purposes of this paragraph in determining whether the corporation has one class of stock outstanding.

(2) *Right of occupancy.* Each stockholder of the corporation, whether or not the stockholder qualifies as a tenant-stockholder under section 216(b)(2) and paragraph (f) of this section, must be entitled to occupy for dwelling purposes an apartment in a building or a unit in a housing development owned or leased by such corporation. The stockholder is not required to occupy the premises. The right as against the corporation to occupy the premises is sufficient. Such right must be conferred on each stockholder solely by reasons of his or her ownership of stock in the corporation. That is, the stock must entitle the owner thereof either to occupy the premises or to a lease of the premises. The fact that the right to continue to occupy the premises is dependent upon the payment of charges to the corporation in the nature of rentals or assessments is immaterial. For taxable years beginning after December 31, 1986, the fact that, by agreement with the cooperative housing corporation, a person or his nominee may not occupy the house or apartment without the prior approval of such corporation will not be taken into account for purposes of this paragraph in the following cases.

(i) In any case where a person acquires stock of the cooperative housing corporation by operation of law, by inheritance, or by foreclosure (or by instrument in lieu of foreclosure),

(ii) In any case where a person other than an individual acquires stock in the cooperative housing corporation, and

(iii) In any case where the person from whom the corporation has acquired the apartments or houses (or leaseholds therein) acquires any stock of the cooperative housing corporation from the corporation not later than one year after the date on which the apartments or houses (or leaseholds therein) are transferred to the corporation by such person. For purposes of the preceding sentence, paragraphs (e)(2) (i) and (ii) of this section will not apply to acquisitions of stock by foreclosure by the person from whom the corporation has acquired the apartments or houses (or leaseholds therein).

(3) *Distributions.* None of the stockholders of the corporation may be entitled, either conditionally or unconditionally, except upon a complete or partial liquidation of the corporation, to receive any distribution other than out of earnings and profits of the corporation.

(4) *Gross income.* Eighty percent or more of the gross income of the corporation for the taxable year of the corporation in which the taxes and interest are paid or incurred must be derived from the tenant-stockholders. For purposes of the 80-percent test, in taxable years beginning after December 31, 1969, gross income attributable to any house or apartment which a governmental unit is entitled to occupy, pursuant to a lease or stock ownership, shall be disregarded.

(f) *Tenant-stockholder*. The term *tenant-stockholder* means a person that is a stockholder in a cooperative housing corporation, as defined in section 216(b)(1) and paragraph (e) of this section, and whose stock is fully paid up in an amount at least equal to an amount shown to the satisfaction of the district director as bearing a reasonable relationship to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the building and the land on which it is situated that is attributable to the apartment or housing unit which such person is entitled to occupy (within the meaning of paragraph (e)(2) of this section). Notwithstanding the preceding sentence, for taxable years beginning before January 1, 1987, tenant-stockholders include only individuals, certain lending institutions, and certain persons from whom the cooperative housing corporation has acquired the apartments or houses (or leaseholds thereon).

(g) *Governmental unit.* For purposes of section 216(b) and this section, the term *governmental unit* means the United States or any of its possessions, a State or any political subdivision thereof, or any agency or instrumentality of the foregoing empowered to acquire shares in a cooperative housing corporation for the purpose of providing housing facilities.

(h) *Examples.* The application of section 216(a) and (b) and this section may be illustrated by the following examples, which refer to apartments but which are equally applicable to housing units:

Example 1. The X Corporation is a cooperative housing corporation within the meaning of section 216. In 1970, at a total cost of $200,000, it purchased a site and constructed thereon a building with 15 apartments. The fair market value of the land and building was $200,000 at the time of completion of the building. The building contains five category A apartment units, each of equal value, and 10 category B apartment units. The total value of all of the category A apartment units is $100,000. The total value of all of the category B apartments is also $100,000. Upon completion of the building, the X Corporation mortgaged the land and building for $100,000, and sold its total authorized capital stock for $100,000. The stock attributable to the category A apartments was purchased by five individuals, each of whom paid $10,000 for 100 shares, or $100 a share. Each certificate for 100 shares of such stock provides that the holder thereof is entitled to a lease of a particular apartment in the building for a specified term of years. The stock attributable to the category B apartments was purchased by a governmental unit for $50,000. Since the shares sold to the tenant-stockholders are valued at $100 per share, the governmental unit is deemed to hold a total of 500 shares. The certificate of such stock provides that the governmental unit is entitled to a lease of all of the category B apartments. All leases provide that the lessee shall pay his proportionate part of the corporation's expenses. In 1970 the original owner of 100 shares of stock attributable to the category A apartments and to the lease to apartment No. 1 made a gift of the stock and lease to A, an individual. The taxable year of A and of the X Corporation is the calendar year. The corporation computes its taxable income on an accrual method, while A computes his taxable income on the cash receipts and disbursements method. In 1971, the X Corporation incurred expenses aggregating $13,800, including $4,000 for the real estate taxes on the land and building, and $5,000 for the interest on the mortgage. In 1972, A pays the X Corporation $1,380, representing his proportionate part of the expenses incurred by the corporation. The entire gross income of the X Corporation for 1971 was derived from the five tenant-stockholders and from the governmental unit. A is entitled under section 216 to a deduction of $900 in computing his taxable income for 1972. The deduction is computed as follows:

Shares of X Corporation owned by A		100
Shares of X Corporation owned by four other tenant-stockholders		400
Shares of X Corporation deemed owned by governmental unit		500
Total shares of X Corporation outstanding		1,000
A's proportionate share of the stock of X Corporation (100/1,000)		1/10
Expenses incurred by X Corporation:		
Real estate taxes	$4,000	
Interest	5,000	
Other	4,800	
Total		$13,800
Amount paid by A		1,380
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		$900
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)		1,380
Amount of A's payment representing real estate taxes and interest (900/1,380 of $1,380)		$900
A's allowable deduction		$900

Since the stock which A acquired by gift was fully paid up by his donor in an amount equal to the portion of the fair market value, as of the date of the original issuance of the stock, of the corporation's equity in the land and building which is attributable to apartment No. 1, the requirement of section 216 in this regard is satisfied. The fair market value at the time of the gift of the corporation's equity attributable to the apartment is immaterial.

Example 2. The facts are the same as in *Example 1* except that the building constructed by the X Corporation contained, in addition to the 15 apartments, business space on the ground floor, which the corporation rented at $2,400 for the calendar year 1971. The corporation deducted the $2,400 from its expenses in determining the amount of the expenses to be prorated among its tenant-stockholders. The amount paid by A to the corporation in 1972 is $1,140 instead of $1,380. More than 80 percent of the gross income of the corporation for 1971 was derived from tenant-stockholders. A is entitled under section 216 to a deduction of $743.48 in computing his taxable income for 1972. The deduction is computed as follows:

Expenses incurred by X Corporation	$13,800.00	
Less: Rent from business space	2,400.00	
Expenses to be prorated among tenant-stockholders		$11,400.00
Amount paid by A		1,140.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)		900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)		1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,140)		743.48
A's allowable deduction		743.48

Since the portion of A's payment allocable to real estate taxes and interest is only $743.48, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1972.

Example 3. The facts are the same as in *Example 1* except that the amount paid by A to the X Corporation in 1972 is $1,000 instead of $1,380. A is entitled under section 216 to a deduction of $652.17 in computing his taxable income for 1972. The deduction is computed as follows:

Amount paid by A	$1,000.00
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900.00
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $13,800)	1,380.00
Amount of A's payment representing real estate taxes and interest (900/1380 of $1,000)	652.17
A's allowable deduction	652.17

Since the portion of A's payment allocable to real estate taxes and interest is only $652.17, that amount instead of $900 is allowable as a deduction in computing A's taxable income for 1972.

Example 4. The facts are the same as in *Example 1* except that X Corporation leases recreational facilities from Y Corporation for use by the tenant-stockholders of X. Under the terms of the lease, X is obligated to pay an annual rental of $5,000 plus all real estate taxes assessed against the facilities. In 1971 X paid, in addition to the $13,800 of expenses enumerated in *Example 1,* $5,000 rent and $1,000 real estate taxes. In 1972 A pays the X Corporation $2,000, no part of which is refunded to him in 1972. A is entitled under section 216 to a deduction of $900 in computing his taxable income for 1972. The deduction is computed as follows:

Expenses to be prorated among tenant-stockholders	$19,800
Amount paid by A	2,000
A's proportionate share of real estate taxes and interest based on his stock ownership (1/10 of $9,000)	900
A's proportionate share of total corporate expenses based on his stock ownership (1/10 of $19,800)	1,980
Amount of A's payment representing real estate taxes and interest (900/1,980 of $1,980)	900
A's allowable deduction	900

The $1,000 of real estate taxes assessed against the recreational facilities constitutes additional rent and hence is not deductible by A as taxes under section 216. A's allowable deduction is limited to his proportionate share of real estate taxes and interest based on stock ownership and cannot be increased by the payment of an amount in excess of his proportionate share.

[T.D. 7092, 36 FR 4597, Mar. 10, 1971; 36 FR 4985, Mar. 16, 1971, as amended by T.D. 8316, 55 FR 42004, Oct. 17, 1990]

§ 1.216–2 Treatment as property subject to depreciation.

(a) *General rule.* For taxable years beginning after December 31, 1961, stock in a cooperative housing corporation (as defined by section 216(b) (1) and paragraph (c) of § 1.216–1) owned by a tenant-stockholder (as defined by section 216(b) (2) and paragraph (d) of § 1.216–1) who uses the proprietary lease or right of tenancy, which was conferred on him solely by reason of his ownership of such stock, in a trade or business or for the production of income shall be treated as property subject to the allowance for depreciation under section 167(a) in the manner and to the extent prescribed in this section.

(b) *Determination of allowance for depreciation*—(1) *In general.* Subject to the special rules provided in subparagraphs (2) and (3) of this paragraph and the limitation provided in paragraph (c) of this section, the allowance for depreciation for the taxable year with respect to stock of a tenant-stockholder, subject to the extent provided in this section to an allowance for depreciation, shall be determined:

(i) By computing the amount of depreciation (amortization in the case of a leasehold) which would be allowable under one of the methods of depreciation prescribed in section 167(b) and the regulations thereunder (in paragraph (a) of § 1.162–11 and § 1.167(a)–4 in the case of a leasehold) in respect of the depreciable (amortizable) real property owned by the cooperative housing corporation in which such tenant-stockholder has a proprietary lease or right of tenancy,

(ii) By reducing the amount of depreciation (amortization) so computed in the same ratio as the rentable space in such property which is not subject to a proprietary lease or right of tenancy by reason of stock ownership but which is held for rental purposes bears to the total rentable space in such property, and

(iii) By computing such tenant-stockholder's proportionate share of such annual depreciation (amortization), so reduced.

As used in this section, the terms *depreciation* and *depreciable real property* include amortization and amortizable leasehold of real property. As used in this section, the tenant-stockholder's proportionate share is that proportion which stock of the cooperative housing corporation owned by the tenant-stockholder is of the total outstanding stock of the corporation, including any stock held by the corporation. In order to determine whether a tenant-stockholder may use one of the methods of depreciation prescribed in section 167(b) (2), (3), or (4) for purposes of subdivision (i) of this subparagraph, the limitations provided in section 167(c) on the use of such methods of depreciation shall be applied with respect to the depreciable real property owned by the cooperative housing corporation in which the tenant-stockholder has a proprietary lease or right of tenancy, rather than with respect to the stock in the cooperative housing corporation owned by the tenant-stockholder or with respect to the proprietary lease or right of tenancy conferred on the tenant-stockholder by reason of his ownership of such stock. The allowance for depreciation determined under this subparagraph shall be properly adjusted where only a portion of the property occupied under a proprietary lease or right of tenancy is used in a trade or business or for the production of income.

(2) *Stock acquired subsequent to first offering.* Except as provided in subparagraph (3), in the case of a tenant-stockholder who purchases stock other than

as part of the first offering of stock by the corporation, the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph shall be the amount obtained by:

(i) Multiplying the taxpayer's cost per share by the total number of outstanding shares of stock of the corporation, including any shares held by the corporation,

(ii) Adding thereto the mortgage indebtedness to which such depreciable real property is subject on the date of purchase of such stock, and

(iii) Subtracting from the sum so obtained the portion thereof not properly allocable as of the date such stock was purchased to the depreciable real property owned by the cooperative housing corporation in which such tenant-stockholder has a proprietary lease or right of tenancy.

In order to prevent an overstatement or understatement of the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph, appropriate adjustment for purposes of the computations described in subdivisions (i) and (ii) of this subparagraph shall be made in respect of prepayments and delinquencies on account of the corporation's mortgage indebtedness. Thus, for purposes of subdivision (i) of this subparagraph, the taxpayer's cost per share shall be reduced by an amount determined by dividing the total mortgage indebtedness prepayments in respect of the shares purchased by the taxpayer by the number of such shares. For purposes of subdivision (ii) of this subparagraph, the mortgage indebtedness shall be increased by the sum of all prepayments applied in reduction of the mortgage indebtedness and shall be decreased by any amount due under the terms of the mortgage and unpaid.

(3) *Conversion subsequent to date of acquisition.* In the case of a tenant-stockholder whose proprietary lease or right of tenancy is converted, in whole or in part, to use in a trade or business or for the production of income on a date subsequent to the date on which he acquired the stock conferring on him such lease or right of tenancy, the basis of the depreciable real property for purposes of the computation required by subparagraph (1)(i) of this paragraph shall be the fair market value of such depreciable real property on the date of the conversion if the fair market value is less than the adjusted basis of such property in the hands of the cooperative housing corporation provided in section 1011 without taking into account any adjustment for depreciation required by section 1016(a)(2). Such fair market value shall be deemed to be equal to the adjusted basis of such property, taking into account adjustments required by section 1016(a)(2) computed as if the corporation had used the straight line method of depreciation, in the absence of evidence establishing that the fair market value so attributed to the property is unrealistic. In the case of a tenant-stockholder who purchases stock other than as part of the first offering of stock of the corporation, and at a later date converts his proprietary lease to use for business or production of income:

(i) The adjusted basis of the cooperative housing corporation's depreciable real property without taking into account any adjustment for depreciation shall be the amount determined in accordance with subdivisions (i), (ii), and (iii) of subparagraph (2) of this paragraph, and

(ii) The fair market value shall be deemed to be equal to such adjusted basis reduced by the amount of depreciation, computed under the straight line method, which would have been allowable in respect of depreciable real property having a cost or other basis equal to the amount representing such adjusted basis in the absence of evidence establishing that the fair market value so attributed to the property is unrealistic.

(c) *Limitation.* If the allowance for depreciation for the taxable year determined in accordance with the provisions of paragraph (b) of this section exceeds the adjusted basis (provided in section 1011) of the stock described in paragraph (a) of this section allocable to the tenant-stockholder's proprietary lease or right of tenancy used in a trade or business or for the production of income, such excess is not allowable as a deduction. For taxable years beginning after December 31, 1986, such excess, subject to the provisions of this paragraph (c), is allowable as a deduction for depreciation in the succeeding taxable year. To determine the portion of the adjusted basis of such stock which is allocable to such proprietary lease or right of tenancy, the adjusted basis is reduced by taking into account the same factors as are taken into account under paragraph (b)(1) of this section in determining the allowance for depreciation.

(d) *Examples.* The provisions of section 216(c) and this section may be illustrated by the following examples:

Example 1. The Y corporation, a cooperative housing corporation within the meaning of section 216, in 1961 purchased a site and constructed thereon a building with 10 apartments at a total cost of $250,000 ($200,000 being allocable to the building and $50,000 being allocable to the land). Such building was completed on January 1, 1962, and at that time had an estimated useful life of 50 years, with an estimated salvage value of $20,000. Each apartment is of equal value. Upon completion of the building, Y corporation mortgaged the land and building for $150,000 and sold its total authorized capital stock, consisting of 1000 shares of common stock, for $100,000. The stock was purchased by 10 individuals each of whom paid $10,000 for 100 shares. Each certificate for 100 shares provides that the holder thereof is entitled to a proprietary lease of a particular apartment in the building. Each lease provides that the lessee shall pay his proportionate share of the corporation's expenses including an amount on account of the curtailment of Y's mortgage indebtedness. B, a calendar year taxpayer, is the original owner of 100 shares of stock in Y corporation. On January 1, 1962, B subleases his apartment for a term of 5 years. B's stock in Y corporation is treated as property subject to the allowance for depreciation under section 167(a), and B, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1962 with respect to such stock as follows:

Y's basis in the building	$200,000
Less: Estimated salvage value	$20,000
Y's basis for depreciation	$180,000
Annual straight line depreciation on Y's building (1/50 of $180,000)	$3,600
Proportion of outstanding shares of stock of Y corporation (1,000) owned by B (100)	1/10
B's proportionate share of annual depreciation (1/10 of $3,600)	$360
Depreciation allowance for 1962 with respect to B's stock (if the limitation in paragraph (c) of this section is not applicable)	$360

Example 2. The facts are the same as in *Example 1* except that the building constructed by Y corporation contained, in addition to the 10 apartments, space on the ground floor for 2 stores which were rented to persons who do not have a proprietary lease of such space by reason of stock ownership. Y corporation's building has a total area of 16,000 square feet, the 10 apartments in such building have an area of 10,000 square feet, and the 2 stores on the ground floor have an area of 2,000 square feet. Thus, the total rentable space in Y corporation's building is 12,000 square feet. B, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1962 with respect to his stock in Y corporation as follows:

Y's basis in the building	$200,000
Less: Estimated salvage value	20,000
Y's basis for depreciation	180,000
Annual straight line depreciation on Y's building (1/50 of $180,000)	3,600
Less: Amount representing rentable space not subject to proprietary lease but held for rental purposes over total rentable space 2,000 ÷ 12,000 (of $3,600)	600
Annual depreciation, as reduced	3,000
B's proportionate share of annual depreciation (1/10 of $3,000)	300
Depreciation allowance for 1962 with respect to B's stock (if the limitation in paragraph (c) of this section is not applicable)	300

Example 3. The facts are the same as in *Example 1* except that B occupies his apartment from January 1, 1962, until December 31, 1966, and that on January 1, 1967, B sells his stock to C, an individual, for $15,000. C thereby obtains a proprietary lease from Y corporation with the same rights and obligations as B's lease provided. Y corporation's records disclose that its outstanding mortgage indebtedness is $135,000 on January 1, 1967. C, a physician, uses the entire apartment solely as an office. C's stock in Y corporation is treated as property subject to the allowance for depreciation under section 167(a), and C, who uses the straight line method of depreciation for purposes of the computation prescribed by paragraph (b)(1)(i) of this section, computes the allowance for depreciation for the taxable year 1967 with respect to such stock as follows:

Price paid for each share of stock in Y corporation purchased by C on 1–1–67 ($15,000 ÷ 100)	$150
Per share price paid by C multiplied by total shares of stock in Y corporation outstanding on 1–1–67 ($150 × 1,000)	150,000
Y's mortgage indebtedness outstanding on 1–1–67	135,000

	285,000
Less: Amount attributable to land (assumed to be 1/5 of $285,000)	57,000
	228,000
Less: Estimated salvage value	20,000
Basis of Y's building for purposes of computing C's depreciation	208,000
Annual straight line depreciation (1/45 of $208,000)	4,622.22
C's proportionate share of annual depreciation (1/10 of $4,622.22)	462.22
Depreciation allowance for 1967 with respect to C's stock (if the limitation in paragraph (c) of this section is not applicable)	462.22

[T.D. 6725, 29 FR 5665, Apr. 29, 1964, as amended by T.D. 8316, 55 FR 42006, Oct. 17, 1990]

§ 1.217–1 Deduction for moving expenses paid or incurred in taxable years beginning before January 1, 1970.

(a) *Allowance of deduction*—(1) *In general.* Section 217(a) allows a deduction from gross income for moving expenses paid or incurred by the taxpayer during the taxable year in connection with the commencement of work as an employee at a new principal place of work. Except as provided in section 217, no deduction is allowable for any expenses incurred by the taxpayer in connection with moving himself, the members of his family or household, or household goods and personal effects. The deduction allowable under this section is only for expenses incurred after December 31, 1963, in taxable years ending after such date and beginning before January 1, 1970, except in cases where a taxpayer makes an election under paragraph (g) of §1.217–2 with respect to moving expenses paid or incurred before January 1, 1971, in connection with the commencement of work by such taxpayer as an employee at a new principal place of work of which such taxpayer has been notified by his employer on or before December 19, 1969. To qualify for the deduction the expenses must meet the definition of the term ''moving expenses'' provided in section 217(b); the taxpayer must meet the conditions set forth in section 217(c); and, if the taxpayer receives a reimbursement or other expense allowance for an item of expense, the deduction for the portion of the expense reimbursed is allowable only to the extent that such reimbursement or other expense allowance is included in his gross income as provided in section 217(e). The deduction is allowable only to a taxpayer who pays or incurs moving expenses in connection with his commencement of work as an employee and is not allowable to a taxpayer who pays or incurs such expenses in connection with his commencement of work as a self-employed individual. The term *employee* as used in this section has the same meaning as in §31.3401(c)–1 of this chapter (Employment Tax Regulations). All references to section 217 in this section are to section 217 prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577).

(2) *Commencement of work.* To be deductible, the moving expenses must be paid or incurred by the taxpayer in connection with the commencement of work by him at a new principal place of work (see paragraph (c)(3) of this section for a discussion of the term *principal place of work*). While it is not necessary that the taxpayer have a contract or commitment of employment prior to his moving to a new location, the deduction is not allowable unless employment actually does occur. The term *commencement* includes (i) the beginning of work by a taxpayer for the first time or after a substantial period of unemployment or part-time employment, (ii) the beginning of work by a taxpayer for a different employer, or (iii) the beginning of work by a taxpayer for the same employer at a new location. To qualify as being in connection with the commencement of work, the move for which moving expenses are incurred must bear a reasonable proximity both in time and place to such commencement. In general, moving expenses incurred within one year of the date of the commencement of work are considered to be reasonably proximate to such commencement. Moving expenses incurred in relocating the taxpayer's residence to a location which is farther from his new principal place of work than was his former residence are not generally to be considered as incurred in connection with such commencement of work. For example, if A is transferred by his employer from place X to place Y and A's old residence while he worked at place

X is 25 miles from Y, A will not generally be entitled to deduct moving expenses in moving to a new residence 40 miles from Y even though the minimum distance limitation contained in section 217(c)(1) is met. If, however, A is required, as a condition of his employment, to reside at a particular place, or if such residency will result in an actual decrease in his commuting time or expense, the expenses of the move may be considered as incurred in connection with his commencement of work at place Y.

(b) *Definition of moving expenses*—(1) *In general.* Section 217(b) defines the term *moving expenses* to mean only the reasonable expenses (i) of moving household goods and personal effects from the taxpayer's former residence to his new residence, and (ii) of traveling (including meals and lodging) from the taxpayer's former residence to his new place of residence. The test of deductibility thus is whether the expenses are reasonable and are incurred for the items set forth in (i) and (ii) above.

(2) *Reasonable expenses.* (i) The term *moving expenses* includes only those expenses which are reasonable under the circumstances of the particular move. Generally, expenses are reasonable only if they are paid or incurred for movement by the shortest and most direct route available from the taxpayer's former residence to his new residence by the conventional mode or modes of transportation actually used and in the shortest period of time commonly required to travel the distance involved by such mode. Expenses paid or incurred in excess of a reasonable amount are not deductible. Thus, if moving or travel arrangements are made to provide a circuitous route for scenic, stopover, or other similar reasons, the additional expenses resulting therefrom are not deductible since they do not meet the test of reasonableness.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A, an employee of the M Company works and maintains his principal residence in Boston, Massachusetts. Upon receiving orders from his employer that he is to be transferred to M's Los Angeles, California office, A motors to Los Angeles with his family with stopovers at various cities between Boston and Los Angeles to visit friends and relatives. In addition, A detours into Mexico for sight-seeing. Because of the stopovers and tour into Mexico, A's travel time and distance are increased over what they would have been had he proceeded directly to Los Angeles. To the extent that A's route of travel between Boston and Los Angeles is in a generally southwesterly direction it may be said that he is traveling by the shortest and most direct route available by motor vehicle. Since A's excursion into Mexico is away from the usual Boston-Los Angeles route, the portion of the expenses paid or incurred attributable to such excursion is not deductible. Likewise, that portion of the expenses attributable to A's delays en route not necessitated by reasons of rest or repair of his vehicle are not deductible.

(3) *Expenses of moving household goods and personal effects.* Expenses of moving household goods and personal effects include expenses of transporting such goods and effects owned by the taxpayer or a member of his household from the taxpayer's former residence to his new residence, and expenses of packing, crating and in-transit storage and insurance for such goods and effects. Expenses paid or incurred in moving household goods and personal effects to a taxpayer's new residence from a place other than his former residence are allowable, but only to the extent that such expenses do not exceed the amount which would be allowable had such goods and effects been moved from the taxpayer's former residence. Examples of items not deductible as moving expenses include, but are not limited to, storage charges (other than in-transit), costs incurred in the acquisition of property, costs incurred and losses sustained in the disposition of property, penalties for breaking leases, mortgage penalties, expenses of refitting rugs or draperies, expenses of connecting or disconnecting utilities, losses sustained on the disposal of memberships in clubs, tuition fees, and similar items.

(4) *Expenses of traveling.* Expenses of traveling include the cost of transportation and of meals and lodging en route (including the date of arrival) of both the taxpayer and members of his household, who have both the taxpayer's former residence and the taxpayer's new residence as their principal place of abode, from the taxpayer's

former residence to his new place of residence. Expenses of traveling do not include, for example: living or other expenses of the taxpayer and members of his household following their date of arrival at the new place of residence and while they are waiting to enter the new residence or waiting for their household goods to arrive; expenses in connection with house or apartment hunting; living expenses preceding the date of departure for the new place of residence; expenses of trips for purposes of selling property; expenses of trips to the former residence by the taxpayer pending the move by his family to the new place of residence; or any allowance for depreciation. The deduction for traveling expenses is allowable for only one trip made by the taxpayer and members of his household; however, it is not necessary that the taxpayer and all members of his household travel together or at the same time.

(5) *Residence.* The term *former residence* refers to the taxpayer's principal residence before his departure for his new principal place of work. The term *new residence* refers to the taxpayer's principal residence within the general location of his new principal place of work. Thus, neither term includes other residences owned or maintained by the taxpayer or members of his family or seasonal residences such as a summer beach cottage. Whether or not property is used by the taxpayer as his residence, and whether or not property is used by the taxpayer as his principal residence (in the case of a taxpayer using more than one property as a residence), depends upon all the facts and circumstances in each case. Property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or similar dwelling. The term *new place of residence* generally includes the area within which the taxpayer might reasonably be expected to commute to his new principal place of work. The application of the terms *former residence*, *new residence* and *new place of residence* as defined in this paragraph and as used in section 217(b)(1) may be illustrated in the following manner: Expenses of moving household goods and personal effects are moving expenses when paid or incurred for transporting such items from the taxpayer's former residence to the taxpayer's new residence (such as from one street address to another). Expenses of traveling, on the other hand, are limited to those incurred between the taxpayer's former residence (a geographic point) and his new place of residence (a commuting area) up to and including the date of arrival. The date of arrival is the day the taxpayer secures lodging within that commuting area, even if on a temporary basis.

(6) *Individuals other than taxpayer.* In addition to the expenses set forth in section 217(b)(1) which are attributable to the taxpayer alone, the same type of expenses attributable to certain individuals other than the taxpayer, if paid or incurred by the taxpayer, are deductible. Those other individuals must (i) be members of the taxpayer's household, and (ii) have both the taxpayer's former residence and his new residence as their principal place of abode. A member of the taxpayer's household may not be, for example, a tenant residing in the taxpayer's residence, nor an individual such as a servant, governess, chauffeur, nurse, valet, or personal attendant.

(c) *Conditions for allowance*—(1) *In general.* Section 217(c) provides two conditions which must be satisfied in order for a deduction of moving expenses to be allowed under section 217(a). The first is a minimum distance requirement prescribed by section 217(c)(1), and the second is a minimum period of employment requirement prescribed by section 217(c)(2).

(2) *Minimum distance.* For purposes of applying the minimum distance requirement of section 217(c)(1) all taxpayers are divided into one or the other of the following categories: taxpayers having a former principal place of work, and taxpayers not having a former principal place of work. In this latter category are individuals who are seeking full-time employment for the first time (for example, recent high school or college graduates), or individuals who are re-entering the labor force after a substantial period of unemployment or part-time employment.

(i) In the case of a taxpayer having a former principal place of work, section 217(c)(1)(A) provides that no deduction is allowable unless the distance between his new principal place of work and his former residence exceeds by at least 20 miles the distance between his former principal place of work and such former residence.

(ii) In the case of a taxpayer not having a former principal place of work, section 217(c)(1)(B) provides that no deduction is allowable unless the distance between his new principal place of work and his former residence is at least 20 miles.

(iii) For purposes of measuring distances under section 217(c)(1) all computations are to be made on the basis of a straight-line measurement.

(3) *Principal place of work.* (i) A taxpayer's ''principal place of work'' usually is the place at which he spends most of his working time. Generally, where a taxpayer performs services as an employee, his principal place of work is his employer's plant, office, shop, store or other property. However, a taxpayer may have a principal place of work even if there is no one place at which he spends a substantial portion of his working time. In such case, the taxpayer's principal place of work is the place at which his business activities are centered—for example, because he reports there for work, or is otherwise required either by his employer or the nature of his employment to ''base'' his employment there. Thus, while a member of a railroad crew, for example, may spend most of his working time aboard a train, his principal place of work is his home terminal, station, or other such central point where he reports in, checks out, or receives instructions. In those cases where the taxpayer is employed by a number of employers on a relatively short-term basis, and secures employment by means of a union hall system (such as a construction or building trades worker), the taxpayer's principal place of work would be the union hall.

(ii) In cases where a taxpayer has more than one employment (i.e., more than one employer at any particular time) his principal place of work is usually determined with reference to his principal employment. The location of a taxpayer's principal place of work is necessarily a question of fact which must be determined on the basis of the particular circumstances in each case. The more important factors to be considered in making a factual determination regarding the location of a taxpayer's principal place of work are (*a*) the total time ordinarily spent by the taxpayer at each place, (*b*) the degree of the taxpayer's business activity at each place, and (*c*) the relative significance of the financial return to the taxpayer from each place.

(iii) In general, a place of work is not considered to be the taxpayer's principal place of work for purposes of this section if the taxpayer maintains an inconsistent position, for example, by claiming an allowable deduction under section 162 (relating to trade or business expenses) for traveling expenses ''while away from home'' with respect to expenses incurred while he is not away from such place of work and after he has incurred moving expenses for which a deduction is claimed under this section.

(4) *Minimum period of employment.* Under section 217(c)(2), no deduction is allowed unless, during the 12-month period immediately following the taxpayer's arrival in the general location of his new principal place of work, he is a full-time employee, in such general location, during at least 39 weeks.

(i) The 12-month period and the 39-week period set forth in section 217(c)(2) are measured from the date of the taxpayer's arrival in the general location of his new principal place of work. Generally, the taxpayer's date of arrival is the date of the termination of the last trip preceding the taxpayer's commencement of work on a regular basis, regardless of the date on which the taxpayer's family or household goods and effects arrive.

(ii) It is not necessary that the taxpayer remain in the employ of the same employer for 39 weeks, but only that he be employed in the same general location of his new principal place of work during such period. The *general location* of the new principal place of work refers to the area within which an individual might reasonably be expected to commute to such place of work, and will usually be the same area as is known as the *new place of residence*; see paragraph (b)(5) of this section.

(iii) Only a week during which the taxpayer is a full-time employee qualifies as a week of work for purposes of the 39-week requirement of section 217(c)(2). Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. In the case of occupations where employment is on a seasonal basis, weeks occuring in the off-season when no work is required or available (as the case may be) may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off-season period and the off-season period is less than 6 months. Thus, a school teacher whose employment contract covers a 12-month period and who teaches on a full-time basis for more than 6 months in fulfillment of such contract is considered a full-time employee during the entire 12-month period. A taxpayer will not be deemed as other than a full-time employee during any week merely because of periods of involuntary temporary absence from work, such as those due to illness, strikes, shutouts, layoffs, natural disasters, etc.

(iv) In the case of taxpayers filing a joint return, either spouse may satisfy this 39-week requirement. However, weeks worked by one spouse may not be added to weeks worked by the other spouse in order to satisfy such requirement.

(v) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is an electrician residing in New York City. Having heard of the possibility of better employment prospects in Denver, Colorado, he moves himself, his family and his household goods and personal effects, at his own expense, to Denver where he secures employment with the M Aircraft Corporation. After working full-time for 30 weeks his job is terminated, and he subsequently moves to and secures employment in Los Angeles, California, which employment lasts for more than 39 weeks. Since A was not employed in the general location of his new principal place of employment while in Denver for at least 39 weeks, no deduction is allowable for moving expenses paid or incurred between New York City and Denver. A will be allowed to deduct only those moving expenses attributable to his move from Denver to Los Angeles, assuming all other conditions of section 217 are met.

Example 2. Assume the same facts as in *Example 1*, except that B, A's wife, secures employment in Denver at the same time as A, and that she continues to work in Denver for at least 9 weeks after A's departure for Los Angeles. Since she has met the 39-week requirement in Denver, and assuming all other requirements of section 217 are met, the moving expenses paid by A attributable to the move from New York City to Denver will be allowed as a deduction, provided A and B filed a joint return.

Example 3. Assume the same facts as in *Example 1*, except that B, A's wife, secures employment in Denver on the same day that A departs for Los Angeles, and continues to work in Denver for 9 weeks thereafter. Since neither A (who has worked 30 weeks) nor B (who has worked 9 weeks) has independently satisfied the 39-week requirement, no deduction for moving expenses attributable to the move from New York City to Denver is allowable.

(d) *Rules for application of section 217(c)(2)*—(1) *Inapplicability of 39-week test to reimbursed expenses.* (i) Paragraph (1) of section 217(d) provides that the 39-week employment condition of section 217(c)(2) does not apply to any moving expense item to the extent that the taxpayer receives reimbursement or other allowance from his employer for such item. A reimbursement or other allowance to an employee for expenses of moving, in the absence of a specific allocation by the employer, is allocated first to items deductible under section 217(a) and then, if a balance remains, to items not so deductible.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a recent college graduate, with his residence in Washington, DC, is hired by the M Corporation in San Francisco, California. Under the terms of the employment contract, M agrees to reimburse A for three-fifths of his moving expenses from Washington to San Francisco. A moves to San Francisco, and pays $1,000 for expenses incurred, for which he is reimbursed $600 by M. After working for M for a period of 3 months, A becomes dissatisfied with the job and returns to Washington to continue his education. Since he has failed to satisfy the 39-week requirement of section 217(c)(2) the expenses totaling $400 for which A has received no reimbursement are not deductible.

Under the special rule of section 217(d)(1), however, the deduction for the $600 reimbursed moving expenses is not disallowed by reason of section 217(c)(2).

Example 2. B, a self-employed accountant, who works and resides in Columbus, Ohio, is hired by the N Company in St. Petersburg, Florida. Pursuant to its policy with respect to newly hired employees, N agrees to reimburse B to the extent of $1,000 of the expenses incurred by him in connection with his move to St. Petersburg, allocating $700 for the items specified in section 217(b)(1), and $300 for "temporary living expenses." B moves to St. Petersburg, and incurs $800 of "moving expenses" and $300 of "temporary living expenses" in St. Petersburg. B receives reimbursement of $1,000 from N, which amount is included in his gross income. Assuming B fails to satisfy the 39-week test of section 217(c)(2), he will nevertheless be allowed to deduct $700 as a moving expense. On the other hand, had N made no allocation between deductible and non-deductible items, B would have been allowed to deduct $800 since, in the absence of a specific allocation of the reimbursement by N, it is presumed that the reimbursement was for items specified in section 217(b)(1) to the extent thereof.

(2) *Election of deduction before 39-week test is satisfied.* (i) Paragraph (2) of section 217(d) provides a special rule which applies in those cases where a taxpayer paid or incurred, in a particular taxable year, moving expenses which would be deductible in that taxable year except for the fact that the 39-week employment condition of section 217(c)(2) has not been satisfied before the time prescribed by law (including extensions thereof) for filing the return for such taxable year. The rule provides that where a taxpayer has paid or incurred moving expenses and as of the date prescribed by section 6072 for filing his return for such taxable year, including extensions thereof as may be allowed under section 6081, there remains unexpired a sufficient portion of the 12-month period so that it is still possible for the taxpayer to satisfy the 39-week requirement, then the taxpayer may elect to claim a deduction for such moving expenses on the return for such taxable year. The election shall be exercised by taking the deduction on the return filed within the time prescribed by section 6072 (including extensions as may be allowed under section 6081). It is not necessary that the taxpayer wait until the date prescribed by law for filing his return in order to make the election. He may make the election on an early return based upon the facts known on the date such return is filed. However, an election made on an early return will become invalid if, as of the date prescribed by law for filing the return, it is not possible for the taxpayer to satisfy the 39-week requirement.

(ii) In the event that a taxpayer does not elect to claim a deduction for moving expenses on the return for the taxable year in which such expenses were paid or incurred in accordance with (i) of this subparagraph, and the 39-week employment condition of section 217(c)(2) (as well as all other requirements of section 217) is subsequently satisfied, then the taxpayer may file an amended return for the taxable year in which such moving expenses were paid or incurred on which he may claim a deduction under section 217. The taxpayer may, in lieu of filing an amended return, file a claim for refund based upon the deduction allowable under section 217.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is transferred by his employer, M, from Boston, Massachusetts, to Cleveland, Ohio, and begins working there on November 1, 1964, followed by his family and household goods and personal effects on November 15, 1964. Moving expenses are paid or incurred by A in 1964 in connection with this move. On April 15, 1965, when A files his income tax return for the year 1964, A has been a full-time employee in Cleveland for approximately 24 weeks. Notwithstanding the fact that as of April 15, 1965, A has not satisfied the 39-week employment condition of section 217(c)(2) he may nevertheless elect to claim his 1964 moving expenses on his 1964 income tax return since there is still sufficient time remaining before November 1, 1965, within which to satisfy the 39-week requirement.

Example 2. Assume the facts are the same as in *Example 1*, except that as of April 15, 1965, A has left the employ of M, and is in the process of seeking further employment in Cleveland. Since, under these conditions, A may be unsure whether or not he will be able to satisfy the 39-week requirement by November 1, 1965, he may not wish to avail himself of the election provided by section 217(d)(2). In such event, A may wait until he has actually satisfied the 39-week requirement, at which time he may file an amended return claiming as a deduction the moving expenses paid or incurred in 1964. A may, in lieu of filing an amended return, file a claim for refund based upon a deduction for such expenses. Should A fail to satisfy the 39-week requirement on or before November 1, 1965, no deduction is allowable for moving expenses incurred in 1964.

(3) *Recapture of deduction where 39-week test is not met.* Paragraph (3) of section 217(d) provides a special rule which applies in cases where a taxpayer has deducted moving expenses under the election provided in section 217(d)(2) prior to his satisfying the 39-week employment condition of section 217(c)(2), and the 39-week test is not satisfied during the taxable year immediately following the taxable year in which the expenses were deducted. In such cases an amount equal to the expenses which were deducted must be included in the taxpayer's gross income for the taxable year immediately following the taxable year in which the expenses were deducted. In the event the taxpayer has deducted moving expenses under the election provided in section 217(d)(2) for the taxable year, and subsequently files an amended return for such year on which he eliminates such deduction, such expenses will not be deemed to have been deducted for purposes of the recapture rule of the preceding sentence.

(e) *Disallowance of deduction with respect to reimbursements not included in gross income.* Section 217(e) provides that no deduction shall be allowed under section 217 for any item to the extent that the taxpayer receives reimbursement or other expense allowance for such item unless the amount of such reimbursement or other expense allowance is included in his gross income. A reimbursement or other allowance to an employee for expenses of moving, in the absence of a specific allocation by the employer, is allocated first to items deductible under section 217(a) and then, if a balance remains, to items not so deductible. For purposes of this section, moving services furnished in-kind, directly or indirectly, by a taxpayer's employer to the taxpayer or members of his household are considered as being a reimbursement or other allowance received by the taxpayer for moving expenses. If a taxpayer pays or incurs moving expenses and either prior or subsequent thereto receives reimbursement or other expense allowance for such item, no deduction is allowed for such moving expenses unless the amount of the reimbursement or other expense allowance is included in his gross income in the year in which such reimbursement or other expense allowance is received. In those cases where the reimbursement or other expense allowance is received by a taxpayer for an item of moving expense subsequent to his having claimed a deduction for such item, and such reimbursement or other expense allowance is properly excluded from gross income in the year in which received, the taxpayer must file an amended return for the taxable year in which the moving expenses were deducted and decrease such deduction by the amount of the reimbursement or other expense allowance not included in gross income. This does not mean, however, that a taxpayer has an option to include or not include in his gross income an amount received as reimbursement or other expense allowance in connection with his move as an employee. This question remains one which must be resolved under section 61(a) (relating to the definition of gross income).

[T.D. 6796, 30 FR 1038, Feb. 2, 1965, as amended by T.D. 7195, 37 FR 13535, July 11, 1972]

§ 1.217–2 Deduction for moving expenses paid or incurred in taxable years beginning after December 31, 1969.

(a) *Allowance of deduction*—(1) *In general.* Section 217(a) allows a deduction from gross income for moving expenses paid or incurred by the taxpayer during the taxable year in connection with his commencement of work as an employee or as a self-employed individual at a new principal place of work. For purposes of this section, amounts are considered as being paid or incurred by an individual whether goods or services are furnished to the taxpayer directly (by an employer, a client, a customer, or similar person) or indirectly (paid to a third party on behalf of the taxpayer by an employer, a client, a customer, or similar person). A cash basis taxpayer will treat moving expenses as being paid for purposes of section 217 and this section in the year in which the taxpayer is considered to have received such payment under section 82 and § 1.82–1. No deduction is allowable under section 162 for any expenses incurred by the taxpayer in connection with moving from one residence to another residence unless such expenses are deductible under section 162 without regard to such change in residence. To qualify for the deduction under section 217 the expenses must meet the definition of the term *moving expenses* provided in section 217(b) and the taxpayer must meet the conditions set forth in section 217(c). The term *employee* as used in this section has the same meaning as in § 31.3401(c)–1 of this chapter (Employment Tax Regulations). The term *self-employed individual* as used in this section is defined in paragraph (f)(1) of this section.

(2) *Expenses paid in a taxable year other than the taxable year in which reimbursement representing such expenses is received.* In general, moving expenses are deductible in the year paid or incurred. If a taxpayer who uses the cash receipts and disbursements method of accounting receives reimbursement for a moving expense in a taxable year other than the taxable year the taxpayer pays such expense, he may elect to deduct such expense in the taxable year that he receives such reimbursement, rather than the taxable year when he paid such expense in any case where:

(i) The expense is paid in a taxable year prior to the taxable year in which the reimbursement is received, or

(ii) The expense is paid in the taxable year immediately following the taxable year in which the reimbursement is received, provided that such expense is paid on or before the due date prescribed for filing the return (determined with regard to any extension of time for such filing) for the taxable year in which the reimbursement is received.

An election to deduct moving expenses in the taxable year that the reimbursement is received shall be made by claiming the deduction on the return, amended return, or claim for refund for the taxable year in which the reimbursement is received.

(3) *Commencement of work.* (i) To be deductible the moving expenses must be paid or incurred by the taxpayer in connection with his commencement of work at a new principal place of work (see paragraph (c)(3) of this section for a discussion of the term *principal place of work*). Except for those expenses described in section 217(b)(1) (C) and (D) it is not necessary for the taxpayer to have made arrangements to work prior to his moving to a new location; however, a deduction is not allowable unless employment or self-employment actually does occur. The term *commencement* includes (*a*) the beginning of work by a taxpayer as an employee or as a self-employed individual for the first time or after a substantial period of unemployment or part-time employment, (*b*) the beginning of work by a taxpayer for a different employer or in the case of a self-employed individual in a new trade or business, or (*c*) the beginning of work by a taxpayer for the same employer or in the case of a self-employed individual in the same trade or business at a new location. To qualify as being in connection with the commencement of work, the move must bear a reasonable proximity both in time and place to such commencement at the new principal place of work. In general, moving expenses incurred within 1 year of the date of the commencement of work are considered to be reasonably proximate in time to such commencement. Moving expenses incurred after the 1-year period may be considered reasonably proximate in time if it can be shown that circumstances existed which prevented the taxpayer from incurring the expenses of moving within the 1-year period allowed. Whether circumstances existed which prevented the taxpayer from incurring the expenses of moving within the period allowed is dependent upon the facts and circumstances of each case. The length of the delay and the fact that the taxpayer may have incurred part of the expenses of the move within the 1-year period allowed shall be taken into account in determining whether expenses incurred after such period are allowable. In general, a move is not considered to be reasonably proximate in place to the commencement of work at the new

princpal place of work where the distance between the taxpayer's new residence and his new principal place of work exceeds the distance between his former residence and his new principal place of work. A move to a new residence which does not satisfy this test may, however, be considered reasonably proximate in place to the commencement of work if the taxpayer can demonstrate, for example, that he is required to live at such residence as a condition of employment or that living at such residence will result in an actual decrease in commuting time or expense. For example, assume that in 1977 A is transferred by his employer to a new principal place of work and the distance between his former residence and his new principal place of work is 35 miles greater than was the distance between his former residence and his former principal place of work. However, the distance between his new residence and his new principal place of work is 10 miles greater than was the distance between his former residence and his new principal place of work. Although the minimum distance requirement of section 217(c)(1) is met the expenses of moving to the new residence are not considered as incurred in connection with A's commencement of work at his new principal place of work since the new residence is not proximate in place to the new place of work. If, however, A can demonstrate, for example, that he is required to live at such new residence as a condition of employment or if living at such new residence will result in an actual decrease in commuting time or expense, the expenses of the move may be considered as incurred in connection with A's commencement of work at his new principal place of work.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. Assume that A is tranferred by his employer from Boston, MA, to Washington, DC. A moves to a new residence in Washington, DC, and commences work on February 1, 1971. A's wife and his two children remain in Boston until June 1972 in order to allow A's children to complete their grade school education in Boston. On June 1, 1972, A sells his home in Boston and his wife and children move to the new residence in Washington, DC. The expenses incurred on June 1, 1972, in selling the old residence and in moving A's family, their household goods, and personal effects to the new residence in Washington are allowable as a deduction although they were incurred 16 months after the date of the commencement of work by A since A has moved to and established a new residence in Washington, DC, and thus incurred part of the total expenses of the move prior to the expiration of the 1-year period.

Example 2. Assume that A is transferred by his employer from Washington, DC, to Baltimore, MD. A commences work on January 1, 1971, in Baltimore. A commutes from his residence in Washington to his new principal place of work in Baltimore for a period of 18 months. On July 1, 1972, A decides to move to and establish a new residence in Baltimore. None of the moving expenses otherwise allowable under section 217 may be deducted since A neither incurred the expenses within 1 year nor has shown circumstances under which he was prevented from moving within such period.

(b) *Definition of moving expenses*—(1) *In general.* Section 217(b) defines the term *moving expenses* to mean only the reasonable expenses (i) of moving household goods and personal effects from the taxpayer's former residence to his new residence, (ii) of traveling (including meals and lodging) from the taxpayer's former residence to his new place of residence, (iii) of traveling (including meals and lodging), after obtaining employment, from the taxpayer's former residence to the general location of his new principal place of work and return, for the principal purpose of searching for a new residence, (iv) of meals and lodging while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after obtaining employment, or (v) of a nature constituting qualified residence sale, purchase, or lease expenses. Thus, the test of deductibility is whether the expenses are reasonable and are incurred for the items set forth in subdivisions (i) through (v) of this subparagraph.

(2) *Reasonable expenses.* (i) The term *moving expenses* includes only those expenses which are reasonable under the circumstances of the particular move. Expenses paid or incurred in excess of a reasonable amount are not deductible. Generally, expenses paid or incurred for movement of household goods and personal effects or for travel (including

meals and lodging) are reasonable only to the extent that they are paid or incurred for such movement or travel by the shortest and most direct route available from the former residence to the new residence by the conventional mode or modes of transportation actually used and in the shortest period of time commonly required to travel the distance involved by such mode. Thus, if moving or travel arrangements are made to provide a circuitous route for scenic, stopover, or other similar reasons, additional expenses resulting therefrom are not deductible since they are not reasonable nor related to the commencement of work at the new principal place of work. In addition, expenses paid or incurred for meals and lodging while traveling from the former residence to the new place of residence or to the general location of the new principal place of work and return or occupying temporary quarters in the general location of the new principal place of work are reasonable only if under the facts and circumstances involved such expenses are not lavish or extravagant.

(ii) The application of this subparagraph may be illustrated by the following example:

Example. A, an employee of the M Company works and maintains his residence in Boston, MA. Upon receiving orders from his employer that he is to be transferred to M's Los Angeles, CA, office, A motors to Los Angeles with his family with stopovers at various cities between Boston and Los Angeles to visit friends and relatives. In addition, A detours into Mexico for sightseeing. Because of the stopovers and tour into Mexico, A's travel time and distance are increased over what they would have been had he proceeded directly to Los Angeles. To the extent that A's route of travel between Boston and Los Angeles is in a generally southwesterly direction it may be said that he is traveling by the shortest and most direct route available by motor vehicle. Since A's excursion into Mexico is away from the usual Boston-Los Angeles route, the portion of the expenses paid or incurred attributable to such excursion is not deductible. Likewise, that portion of the expenses attributable to A's delay en route in visiting personal friends and sightseeing are not deductible.

(3) *Expense of moving household goods and personal effects.* Expenses of moving household goods and personal effects include expenses of transporting such goods and effects from the taxpayer's former residence to his new residence, and expenses of packing, crating, and in-transit storage and insurance for such goods and effects. Such expenses also include any costs of connecting or disconnecting utilities required because of the moving of household goods, appliances, or personal effects. Expenses of storing and insuring household goods and personal effects constitute in-transit expenses if incurred within any consecutive 30-day period after the day such goods and effects are moved from the taxpayer's former residence and prior to delivery at the taxpayer's new residence. Expenses paid or incurred in moving household goods and personal effects to the taxpayer's new residence from a place other than his former residence are allowable, but only to the extent that such expenses do not exceed the amount which would be allowable had such goods and effects been moved from the taxpayer's former residence. Expenses of moving household goods and personal effects do not include, for example, storage charges (other than in-transit), costs incurred in the acquisition of property, costs incurred and losses sustained in the disposition of property, penalties for breaking leases, mortgage penalties, expenses of refitting rugs or draperies, losses sustained on the disposal of memberships in clubs, tuition fees, and similar items. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them subject to the allowable dollar limitations.

(4) *Expenses of traveling from the former residence to the new place of residence.* Expenses of traveling from the former residence to the new place of residence include the cost of transportation and of meals and lodging en route (including the date of arrival) from the taxpayer's former residence to his new place of residence. Expenses of meals and lodging incurred in the general location of the former residence within 1 day after the former residence is no longer suitable for occupancy because of the removal of household goods and personal effects shall be considered as expenses of traveling for purposes of this subparagraph. The

date of arrival is the day the taxpayer secures lodging at the new place of residence, even if on a temporary basis. Expenses of traveling from the taxpayer's former residence to his new place of residence do not include, for example, living or other expenses following the date of arrival at the new place of residence and while waiting to enter the new residence or waiting for household goods to arrive, expenses in connection with house or apartment hunting, living expenses preceding date of departure for the new place of residence (other than expenses of meals and lodging incurred within 1 day after the former residence is no longer suitable for occupancy), expenses of trips for purposes of selling property, expenses of trips to the former residence by the taxpayer pending the move by his family to the new place of residence, or any allowance for depreciation. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them subject to the allowable dollar limitations. The deduction for traveling expenses from the former residence to the new place of residence is allowable for only one trip made by the taxpayer and members of his household; however, it is not necessary that the taxpayer and all members of his household travel together or at the same time.

(5) *Expenses of traveling for the principal purpose of looking for a new residence.* Expenses of traveling, after obtaining employment, from the former residence to the general location of the new principal place of work and return, for the principal purpose of searching for a new residence include the cost of transportation and meals and lodging during such travel and while at the general location of the new place of work for the principal purpose of searching for a new residence. However, such expenses do not include, for example, expenses of meals and lodging of the taxpayer and members of his household before departing for the new principal place of work, expenses for trips for purposes of selling property, expenses of trips to the former residence by the taxpayer pending the move by his family to the place of residence, or any allowance for depreciation. The above expenses may, however, be described in other provisions of section 217(b) and if so a deduction may be allowed for them. The deduction for expenses of traveling for the principal purpose of looking for a new residence is not limited to any number of trips by the taxpayer and by members of his household. In addition, the taxpayer and all members of his household need not travel together or at the same time. Moreover, a trip need not result in acquisition of a lease of property or purchase of property. An employee is considered to have obtained employment in the general location of the new principal place of work after he has obtained a contract or agreement of employment. A self-employed individual is considered to have obtained employment when he has made substantial arrangements to commence work at the new principal place of work (see paragraph (f)(2) of this section for a discussion of the term *made substantial arrangements to commence to work*).

(6) *Expenses of occupying temporary quarters.* Expenses of occupying temporary quarters include only the cost of meals and lodging while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after the taxpayer has obtained employment in such general location. Thus, expenses of occupying temporary quarters do not include, for example, the cost of entertainment, laundry, transportation, or other personal, living family expenses, or expenses of occupying temporary quarters in the general location of the former place of work. The 30 consecutive day period is any one period of 30 consecutive days which can begin, at the option of the taxpayer, on any day after the day the taxpayer obtains employment in the general location of the new principal place of work.

(7) *Qualified residence sale, purchase, or lease expenses.* Qualified residence sale, purchase, or lease expenses (hereinafter "qualified real estate expenses") are only reasonable amounts paid or incurred for any of the following purposes:

(i) Expenses incident to the sale or exchange by the taxpayer or his spouse of the taxpayer's former residence which, but for section 217 (b) and (e), would be taken into account in determining the amount realized on the sale or exchange of the residence. These expenses include real estate commissions, attorneys' fees, title fees, escrow fees, so called ''points'' or loan placement charges which the seller is required to pay, State transfer taxes and similar expenses paid or incurred in connection with the sale or exchange. No deduction, however, is permitted under section 217 and this section for the cost of physical improvements intended to enhance salability by improving the condition or appearance of the residence.

(ii) Expenses incident to the purchase by the taxpayer or his spouse of a new residence in the general location of the new principal place of work which, but for section 217 (b) and (e), would be taken into account in determining either the adjusted basis of the new residence or the cost of a loan. These expenses include attorney's fees, escrow fees, appraisal fees, title costs, so-called ''points'' or loan placement charges not representing payments or prepayments of interest, and similar expenses paid or incurred in connection with the purchase of the new residence. No deduction, however, is permitted under section 217 and this section for any portion of real estate taxes or insurance, so-called ''points'' or loan placement charges which are, in essence, prepayments of interest, or the purchase price of the residence.

(iii) Expenses incident to the settlement of an unexpired lease held by the taxpayer or his spouse on property used by the taxpayer as his former residence. These expenses include consideration paid to a lessor to obtain a release from a lease, attorneys' fees, real estate commissions, or similar expenses incident to obtaining a release from a lease or to obtaining an assignee or a sublessee such as the difference between rent paid under a primary lease and rent received under a sublease. No deduction, however, is permitted under section 217 and this section for the cost of physical improvement intended to enhance marketability of the leasehold by improving the condition or appearance of the residence.

(iv) Expenses incident to the acquisition of a lease by the taxpayer or his spouse. These expenses include the cost of fees or commissions for obtaining a lease, a sublease, or an assignment of an interest in property used by the taxpayer as his new residence in the general location of the new principal place of work. No deduction, however, is permitted under section 217 and this section for payments or prepayments of rent or payments representing the cost of a security or other similar deposit.

Qualified real estate expenses do not include losses sustained on the disposition of property or mortgage penalties, to the extent that such penalties are otherwise deductible as interest.

(8) *Residence.* The term *former residence* refers to the taxpayer's principal residence before his departure for his new principal place of work. The term *new residence* refers to the taxpayer's principal residence within the general location of his new principal place of work. Thus, neither term includes other residences owned or maintained by the taxpayer or members of his family or seasonal residences such as a summer beach cottage. Whether or not property is used by the taxpayer as his principal residence depends upon all the facts and circumstances in each case. Property used by the taxpayer as his principal residence may include a houseboat, a housetrailer, or similar dwelling. The term *new place of residence* generally includes the area within which the taxpayer might reasonably be expected to commute to his new principal place of work.

(9) *Dollar limitations.* (i) Expenses described in subparagraphs (A) and (B) of section 217(b)(1) are not subject to an overall dollar limitation. Thus, assuming all other requirements of section 217 are satisfied, a taxpayer who, in connection with his commencement of work at a new principal place of work, pays or incurs reasonable expenses of moving household goods and personal effects from his former residence to his new place of residence and reasonable expenses of traveling, including meals and lodging, from his former residence to his new place of residence is permitted to deduct the entire amount of these expenses.

(ii) Expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) are subject to an overall dollar limitation for each commencement of work of 3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977), of which the expenses described in subparagraphs (C) and (D) of section 217(b)(1) cannot exceed $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977). The dollar limitation applies to the amount of expenses paid or incurred in connection with each commencement of work and not to the amount of expenses paid or incurred in each taxable year. Thus, for example, a taxpayer who paid or incurred $2,000 of expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) in taxable year 1977 in connection with his commencement of work at a principal place of work and paid or incurred an additional $2,000 of such expenses in taxable year 1978 in connection with the same commencement of work is permitted to deduct the $2,000 of such expenses paid or incurred in taxable year 1977 and only $1,000 of such expenses paid or incurred in taxable year 1978.

(iii) A taxpayer who pays or incurs expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) in connection with the same commencement of work may choose to deduct any combination of such expenses within the dollar amounts specified in subdivision (ii) of this subparagraph. For example, a taxpayer who pays or incurs such expenses in connection with the same commencement of work may either choose to deduct: (*a*) Expenses described in subparagraphs (C) and (D) of section 217(b)(1) to the extent of $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977) before deducting any of the expenses described in subparagraph (E) of such section, or (*b*) expenses described in subparagraph (E) of section 217(b)(1) to the extent of $3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977) before deducting any of the expenses described in subparagraphs (C) and (D) of such section.

(iv) For the purpose of computing the dollar limitation contained in subparagraph (A) of section 217(b)(3) a commencement of work by a taxpayer at a new principal place of work and a commencement of work by his spouse at a new principal place of work which are in the same general location constitute a single commencement of work. Two principal places of work are treated as being in the same general location where the taxpayer and his spouse reside together and commute to their principal places of work. Two principal places of work are not treated as being in the same general location where, as of the close of the taxable year, the taxpayer and his spouse have not shared the same new residence nor made specific plans to share the same new residence within a determinable time. Under such circumstances, the separate commencements of work by a taxpayer and his spouse will be considered separately in assigning the dollar limitations and expenses to the appropriate return in the manner described in subdivisions (v) and (vi) of this subparagraph.

(v) Moving expenses (described in subparagraphs (C), (D), and (E) of section 217(b)(1)), paid or incurred with respect to the commencement of work by both a husband and wife which is considered a single commencement of work under subdivision (iv) of this subparagraph are subject to an overall dollar limitation of $3,000 ($2,500 in the case of a commencement of work in a taxable year beginning before January 1, 1977), per move of which the expenses described in subparagraphs (C) and (D) of section 217(b)(1) cannot exceed $1,500 ($1,000 in the case of a commencement of work in a taxable year beginning before January 1, 1977). If separate returns are filed with respect to the commencement of work by both a husband and wife which is considered a single commencement of work under subdivision (iv) of this subparagraph, moving expenses (described in subparagraphs (C), (D), and (E) of section 217(b)(1)) are subject to an overall dollar limitation of $1,500 ($1,250 in the case of a commencement of work in a taxable year beginning before January 1, 1977), per move of which the expenses described in subparagraphs (C) and (D) of section

217(b)(1) cannot exceed $750 ($500 in the case of a commencement of work in a taxable year beginning before January 1, 1977) with respect to each return. Where moving expenses are paid or incurred in more than 1 taxable year with respect to a single commencement of work by a husband and wife they shall, for purposes of applying the dollar limitations to such move, be subject to a $3,000 and $1,500 limitation ($2,500 and $1,000, respectively, in the case of a commencement of work in a taxable year beginning before January 1, 1977) for all such years that they file a joint return and shall be subject to a separate $1,500 and $750 limitation ($1,250 and $500, respectively, in the case of a commencement of work in a taxable year beginning before January 1, 1977) for all such years that they file separate returns. If a joint return is filed for the first taxable year moving expenses are paid or incurred with respect to a move but separate returns are filed in a subsequent year, the unused portion of the amount which may be deducted shall be allocated equally between the husband and wife in the later year. If separate returns are filed for the first taxable year such moving expenses are paid or incurred but a joint return is filed in a subsequent year, the deductions claimed on their separate returns shall be aggregated for purposes of determining the unused portion of the amount which may be deducted in the later year.

(vi) The application of subdivisions (iv) and (v) of this subparagraph may be illustrated by the following examples:

Example 1. A, who was transferred by his employer, effective January 15, 1977, moved from Boston, MA, to Washington, DC. A's wife was transferred by her employer, effective January 15, 1977, from Boston, MA, to Baltimore, MD. A and his wife reside together at the same new residence. A and his wife are cash basis taxpayers and file a joint return for taxable year 1977. Because A and his wife reside together at the new residence, the commencement of work by both is considered a single commencement of work under subdivision (iv) of this subparagraph. They are permitted to deduct with respect to their commencement of work in Washington and Baltimore up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) of which the expenses described in subparagraphs (C) and (D) of such section cannot exceed $1,500.

Example 2. Assume the same facts as in *Example 1* except that for taxable year 1977, A and his wife file separate returns. Because A and his wife reside together, the commencement of work by both is considered a single commencement of work under subdivision (iv) of this subparagraph. A is permitted to deduct with respect to his commencement of work in Washington up to $1,500 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) of which the expenses described in subparagraphs (C) and (D) cannot exceed $750. A is not permitted to deduct any of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid by his wife in connection with her commencement of work at a new principal place of work. A's wife is permitted to deduct with respect to her commencement of work in Baltimore up to $1,500 of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) that are paid by her of which the expenses described in subparagraphs (C) and (D) cannot exceed $750. A's wife is not permitted to deduct any of the expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid by A in connection with his commencement of work in Washington, DC.

Example 3. Assume the same facts as in *Example 1* except that A and his wife take up separate residences in Washington and Baltimore, do not reside together during the entire taxable year, and have no specific plans to reside together. The commencement of work by A in Washington, DC, and by his wife in Baltimore are considered separate commencements of work since their principal places of work are not treated as being in the same general location. If A and his wife file a joint return for taxable year 1977, the moving expenses described in subparagraphs (C), (D), and (E) of section 217(b)(1) paid in connection with the commencement of work by A in Washington, DC, and his wife in Baltimore, MD, are subject to an overall limitation of $6,000 of which the expenses described in subparagrahs (C) and (D) cannot exceed $3,000. If A and his wife file separate returns for taxable year 1977, A may deduct up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of which the expenses described in subparagraphs (C) and (D) cannot exceed $1,500. A's wife may deduct up to $3,000 of the expenses described in subparagraphs (C), (D), and (E) of which the expenses described in subparagraphs (C) and (D) cannot exceed $1,500.

(10) *Individuals other than taxpayer.* (i) In addition to the expenses set forth in subparagraphs (A) through (D) of section 217(b)(1) attributable to the taxpayer alone, the same type of expenses

attributable to certain individuals other than the taxpayer, if paid or incurred by the taxpayer, are deductible. These other individuals must be members of the taxpayer's household, and have both the taxpayer's former residence and his new residence as their principal place of abode. A member of the taxpayer's household includes any individual residing at the taxpayer's residence who is neither a tenant nor an employee of the taxpayer. Thus, for example, a member of the taxpayer's household may not be an individual such as a servant, governess, chauffeur, nurse, valet, or personal attendant. However, for purposes of this paragraph, a tenant or employee will be considered a member of the taxpayer's household where the tenant or employee is a dependent of the taxpayer as defined in section 152.

(ii) In addition to the expenses set forth in section 217(b)(2) paid or incurred by the taxpayer attributable to property sold, purchased, or leased by the taxpayer alone, the same type of expenses paid or incurred by the taxpayer attributable to property sold, purchased, or leased by the taxpayer's spouse or by the taxpayer and his spouse are deductible providing such property is used by the taxpayer as his principal place of residence.

(c) *Conditions for allowance*—(1) *In general.* Section 217(c) provides two conditions which must be satisfied in order for a deduction of moving expenses to be allowed under section 217(a). The first is a minimum distance condition prescribed by section 217(c)(1), and the second is a minimum period of employment condition prescribed by section 217(c)(2).

(2) *Minimum distance.* For purposes of applying the minimum distance condition of section 217(c)(1) all taxpayers are divided into one or the other of the following categories: Taxpayers having a former principal place of work, and taxpayers not having a former principal place of work. Included in this latter category are individuals who are seeking fulltime employment for the first time either as an employee or on a self- employed basis (for example, recent high school or college graduates), or individuals who are reentering the labor force after a substantial period of unemployment or part-time employment.

(i) In the case of a taxpayer having a former principal place of work, section 217(c)(1)(A) provides that no deduction is allowable unless the distance between the former residence and the new principal place of work exceeds by at least 35 miles (50 miles in the case of expenses paid or incurred in taxable years beginning before January 1, 1977) the distance between the former residence and the former principal place of work.

(ii) In the case of a taxpayer not having a former principal place of work, section 217(c)(1)(B) provides that no deduction is allowable unless the distance between the former residence and the new principal place of work is at least 35 miles (50 miles in the case of expenses paid or incurred in taxable years beginning before January 1, 1977).

(iii) For purposes of measuring distances under section 217(c)(1) the distance between two geographic points is measured by the shortest of the more commonly traveled routes between such points. The shortest of the more commonly traveled routes refers to the line of travel and the mode or modes of transportation commonly used to go between two geographic points comprising the shortest distance between such points irrespective of the route used by the taxpayer.

(3) *Principal place of work.* (i) A taxpayer's *principal place of work* usually is the place where he spends most of his working time. The principal place of work of a taxpayer who performs services as an employee is his employer's plant, office, shop, store, or other property. The principal place of work of a taxpayer who is self-employed is the plant, office, shop, store, or other property which serves as the center of his business activities. However, a taxpayer may have a principal place of work even if there is no one place where he spends a substantial portion of his working time. In such case, the taxpayer's principal place of work is the place where his business activities are centered—for example, because he reports there for work, or is required either by his employer or the nature of his employment to ''base'' his employment there. Thus, while a member of a

railroad crew may spend most of his working time aboard a train, his principal place of work is his home terminal, station, or other such central point where he reports in, checks out, or receives instructions. The principal place of work of a taxpayer who is employed by a number of employers on a relatively short-term basis, and secures employment by means of a union hall system (such as a construction or building trades worker) would be the union hall.

(ii) Where a taxpayer has more than one employment (i.e., the taxpayer is employed by more than one employer, or is self-employed in more than one trade or business, or is an employee and is self-employed at any particular time) his principal place of work is determined with reference to his principal employment. The location of a taxpayer's principal place of work is a question of fact determined on the basis of the particular circumstances in each case. The more important factors to be considered in making this determination are (*a*) the total time ordinarily spent by the taxpayer at each place, (*b*) the degree of the taxpayer's business activity at each place, and (*c*) the relative significance of the financial return to the taxpayer from each place.

(iii) Where a taxpayer maintains inconsistent positions by claiming a deduction for expenses of meals and lodging while away from home (incurred in the general location of the new principal place of work) under section 162 (relating to trade or business expenses) and by claiming a deduction under this section for moving expenses incurred in connection with the commencement of work at such place of work, it will be a question of facts and circumstances as to whether such new place of work will be considered a principal place of work, and accordingly, which category of deductions he will be allowed.

(4) *Minimum period of employment.* (i) Under section 217(c)(2) no deduction is allowed unless:

(*a*) Where a taxpayer is an employee, during the 12-month period immediately following his arrival in the general location of the new principal place of work, he is a full-time employee, in such general location, during at least 39 weeks, or

(*b*) Where a taxpayer is a self-employed individual (including a taxpayer who is also an employee, but is unable to satisfy the requirements of the 39-week test of (a) of this subdivision (i)), during the 24-month period immediately following his arrival in the general location of the new principal place of work, he is a full-time employee or performs services as a self-employed individual on a full-time basis, in such general location, during at least 78 weeks, of which not less than 39 weeks are during the 12-month period referred to above.

Where a taxpayer works as an employee and at the same time performs services as a self-employed individual his principal employment (determined according to subdivision (i) of subparagraph (3) of this paragraph) governs whether the 39-week or 78-week test is applicable.

(ii) The 12-month period and the 39-week period set forth in subparagraph (A) of section 217(c)(2) and the 12- and 24-month periods as well as 39- and 78-week periods set forth in subparagraph (B) of such section are measured from the date of the taxpayer's arrival in the general location of the new principal place of work. Generally, date of arrival is the date of the termination of the last trip preceding the taxpayer's commencement of work on a regular basis and is not the date the taxpayer's family or household goods and effects arrive.

(iii) The taxpayer need not remain in the employ of the same employer or remain self-employed in the same trade or business for the required number of weeks. However, he must be employed in the same general location of the new principal place of work during such period. The *general location* of the new principal place of work refers to a general commutation area and is usually the same area as the "new place of residence"; see paragraph (b)(8) of this section.

(iv) Only those weeks during which the taxpayer is a full-time employee or during which he performs services as a self-employed individual on a full-time basis qualify as a week of work for purposes of the minimum period of employment condition of section 217(c)(2).

(*a*) Whether an employee is a full-time employee during any particular week depends upon the customary practices of the occupation in the geographic area in which the taxpayer works. Where employment is on a seasonal basis, weeks occurring in the off-season when no work is required or available may be counted as weeks of full-time employment only if the employee's contract or agreement of employment covers the off-season period and such period is less than 6 months. Thus, for example, a schoolteacher whose employment contract covers a 12-month period and who teaches on a full-time basis for more than 6 months is considered a full-time employee during the entire 12-month period. A taxpayer will be treated as a full-time employee during any week of involuntary temporary absence from work because of illness, strikes, shutouts, layoffs, natural disasters, etc. A taxpayer will, also, be treated as a full-time employee during any week in which he voluntarily absents himself from work for leave or vacation provided for in his contract or agreement of employment.

(*b*) Whether a taxpayer performs services as a self-employed individual on a full-time basis during any particular week depends on the practices of the trade or business in the geographic area in which the taxpayer works. For example, a self-employed dentist maintaining office hours 4 days a week is considered to perform services as a self-employed individual on a full-time basis providing it is not unusual for other self-employed dentists in the geographic area in which the taxpayer works to maintain office hours only 4 days a week. Where a trade or business is seasonal, weeks occurring during the off-season when no work is required or available may be counted as weeks of performance of services on a full-time basis only if the off-season is less than 6 months and the taxpayer performs services on a full-time basis both before and after the off-season. For example, a taxpayer who owns and operates a motel at a beach resort is considered to perform services as a self-employed individual on a full-time basis if the motel is closed for a period not exceeding 6 months during the off-season and if he performs services on a full-time basis as the operator of a motel both before and after the off-season. A taxpayer will be treated as performing services as a self-employed individual on a full-time basis during any week of involuntary temporary absence from work because of illness, strikes, natural disasters, etc.

(v) Where taxpayers file a joint return, either spouse may satisfy the minimum period of employment condition. However, weeks worked by one spouse may not be added to weeks worked by the other spouse in order to satisfy such condition. The taxpayer seeking to satisfy the minimum period of employment condition must satisfy the condition applicable to him. Thus, if a taxpayer is subject to the 39-week condition and his spouse is subject to the 78-week condition and the taxpayer satisfies the 39-week condition, his spouse need not satisfy the 78-week condition. On the other hand, if the taxpayer does not satisfy the 39-week condition, his spouse in such case must satisfy the 78-week condition.

(vi) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is an electrician residing in New York City. He moves himself, his family, and his household goods and personal effects, at his own expense, to Denver where he commences employment with the M Aircraft Corporation. After working full-time for 30 weeks he voluntarily leaves his job, and he subsequently moves to and commences employment in Los Angeles, CA, which employment lasts for more than 39 weeks. Since A was not employed in the general location of his new principal place of employment in Denver for at least 39 weeks, no deduction is allowable for moving expenses paid or incurred between New York City and Denver. A will be allowed to deduct only those moving expenses attributable to his move from Denver to Los Angeles, assuming all other conditions of section 217 are met.

Example 2. Assume the same facts as in *Example 1*, except that A's wife commences employment in Denver at the same time as A, and that she continues to work in Denver for at least 9 weeks after A's departure for Los Angeles. Since she has met the 39-week requirement in Denver, and assuming all other requirements of section 217 are met, the moving expenses paid by A attributable to the move from New York City to Denver will be allowed as a deduction, provided A and his wife file a joint return. If A and his wife file separate returns moving expenses paid by A's wife attributable to the move from New York City to Denver will be allowed as a deduction on A's wife's return.

Example 3. Assume the same facts as in *Example 1,* except that A's wife commences employment in Denver on the same day that A departs for Los Angeles, and continues to work in Denver for 9 weeks thereafter. Since neither A (who has worked 30 weeks) nor his wife (who has worked 9 weeks) has independently satisfied the 39-week requirement, no deduction for moving expenses attributable to the move from New York City to Denver is allowable.

(d) *Rules for application of section 217(c)(2)*—(1) *Inapplicability of minimum period of employment condition in certain cases.* Section 217(d)(1) provides that the minimum period of employment condition of section 217(c)(2) does not apply in the case of a taxpayer who is unable to meet such condition by reason of:

(i) Death or disability, or

(ii) Involuntary separation (other than for willfull misconduct) from the service of an employer or separation by reason of transfer for the benefit of an employer after obtaining full-time employment in which the taxpayer could reasonably have been expected to satisfy such condition.

For purposes of subdivision (i) of this paragraph disability shall be determined according to the rules in section 72(m)(7) and §1.72–17(f). Subdivision (ii) of this subparagraph applies only where the taxpayer has obtained full-time employment in which he could reasonably have been expected to satisfy the minimum period of employment condition. A taxpayer could reasonably have been expected to satisfy the minimum period of employment condition if at the time he commences work at the new principal place of work he could have been expected, based upon the facts known to him at such time, to satisfy such condition. Thus, for example, if the taxpayer at the time of transfer was not advised by his employer that he planned to transfer him within 6 months to another principal place of work, the taxpayer could, in the absence of other factors, reasonably have been expected to satisfy the minimum employment period condition at the time of the first transfer. On the other hand, a taxpayer could not reasonably have been expected to satisfy the minimum employment condition if at the time of the commencement of the move he knew that his employer's retirement age policy would prevent his satisfying the minimum employment period condition.

(2) *Election of deduction before minimum period of employment condition is satisfied.* (i) Paragraph (2) of section 217(d) provides a rule which applies where a taxpayer paid or incurred, in a taxable year, moving expenses which would be deductible in that taxable year except that the minimum period of employment condition of section 217(c)(2) has not been satisfied before the time prescribed by law for filing the return for such taxable year. The rule provides that where a taxpayer has paid or incurred moving expenses and as of the date prescribed by section 6072 for filing his return for such taxable year (determined with regard to extensions of time for filing) there remains unexpired a sufficient portion of the 12-month or the 24-month period so that it is still possible for the taxpayer to satisfy the applicable period of employment condition, the taxpayer may elect to claim a deduction for such moving expenses on the return for such taxable year. The election is exercised by taking the deduction on the return.

(ii) Where a taxpayer does not elect to claim a deduction for moving expenses on the return for the taxable year in which such expenses were paid or incurred in accordance with subdivision (i) of this subparagraph and the applicable minimum period of employment condition of section 217(c)(2) (as well as all other requirements of section 217) is subsequently satisfied, the taxpayer may file an amended return or a claim for refund for the taxable year such moving expenses were paid or incurred on which he may claim a deduction under section 217.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. A is transferred by his employer from Boston, MA, to Cleveland, OH. He begins working there on November 1, 1970.

Moving expenses are paid by A in 1970 in connection with this move. On April 15, 1971, when he files his income tax return for the year 1970, A has been a full-time employee in Cleveland for approximately 24 weeks. Although he has not satisfied the 39-week employment condition at this time, A may elect to claim his 1970 moving expenses on his 1970 income tax return as there is still sufficient time remaining before November 1, 1971, to satisfy such condition.

Example 2. Assume the same facts as in *Example 1,* except that on April 15, 1971, A has voluntarily left his employer and is looking for other employment in Cleveland. A may not be sure he will be able to meet the 39-week employment condition by November 1, 1971. Thus, he may if he wishes wait until such condition is met and file an amended return claiming as a deduction the expenses paid in 1970. Instead of filing an amended return A may file a claim for refund based on a deduction for such expenses. If A fails to meet the 39-week employment condition on or before November 1, 1971, no deduction is allowable for such expenses.

Example 3. B is a self-employed accountant. He moves from Rochester, NY, to New York, NY, and begins to work there on December 1, 1970. Moving expenses are paid by B in 1970 and 1971 in connection with this move. On April 15, 1971, when he files his income tax return for the year 1970, B has been performing services as a self-employed individual on a full-time basis in New York City for approximately 20 weeks. Although he has not satisfied the 78-week employment condition at this time, A may elect to claim his 1970 moving expenses on his 1970 income tax return as there is still sufficient time remaining before December 1, 1972, to satisfy such condition. On April 15, 1972, when he files his income tax return for the year 1971, B has been performing services as a self-employed individual on a full-time basis in New York City for approximately 72 weeks. Although he has not met the 78-week employment condition at this time, B may elect to claim his 1971 moving expenses on his 1971 income tax return as there is still sufficient time remaining before December 1, 1972, to satisfy such requirement.

(3) *Recapture of deduction.* Paragraph (3) of section 217(d) provides a rule which applies where a taxpayer has deducted moving expenses under the election provided in section 217(d)(2) prior to satisfying the applicable minimum period of employment condition and such condition cannot be satisfied at the close of a subsequent taxable year. In such cases an amount equal to the expenses deducted must be included in the taxpayer's gross income for the taxable year in which the taxpayer is no longer able to satisfy such minimum period of employment condition. Where the taxpayer has deducted moving expenses under the election provided in section 217(d)(2) for the taxable year and subsequently files an amended return for such year on which he does not claim the deduction, such expenses are not treated as having been deducted for purposes of the recapture rule of the preceding sentence.

(e) *Denial of double benefit*—(1) *In general.* Section 217(e) provides a rule for computing the amount realized and the basis where qualified real estate expenses are allowed as a deduction under section 217(a).

(2) *Sale or exchange of residence.* Section 217(e) provides that the amount realized on the sale or exchange of a residence owned by the taxpayer, by the taxpayer's spouse, or by the taxpayer and his spouse and used by the taxpayer as his principal place of residence is not decreased by the amount of any expenses described in subparagraph (A) of section 217(b)(2) and deducted under section 217(a). For the purposes of section 217(e) and of this paragraph the term amount realized'' has the same meaning as under section 1001(b) and the regulations thereunder. Thus, for example, if the taxpayer sells a residence used as his principal place of residence and real estate commissions or similar expenses described in subparagraph (A) of section 217(b)(2) are deducted by him pursuant to section 217(a), the amount realized on the sale of the residence is not reduced by the amount of such real estate commissions or such similar expenses described in subparagraph (A) of section 217(b)(2).

(3) *Purchase of a residence.* Section 217(e) provides that the basis of a residence purchased or received in exchange for other property by the taxpayer, by the taxpayer's spouse, or by the taxpayer and his spouse and used by the taxpayer as his principal place of residence is not increased by the amount of any expenses described in subparagraph (B) of section 217(b)(2) and deducted under section 217(a). For the purposes of section 217(e) and of this paragraph the term *basis* has the same meaning as under section 1011 and the regulations thereunder. Thus,

for example, if a taxpayer purchases a residence to be used as his principal place of residence and attorneys' fees or similar expenses described in subparagraph (B) of section 217(b)(2) are deducted pursuant to section 217(a), the basis of such residence is not increased by the amount of such attorneys' fees or such similar expenses described in subparagraph (B) of section 217(b)(2).

(4) *Inapplicability of section 217(e).* (i) Section 217(e) and subparagraphs (1) through (3) of this paragraph do not apply to any expenses with respect to which an amount is included in gross income under section 217(d)(3). Thus, the amount of any expenses described in subparagraph (A) of section 217(b)(2) deducted in the year paid or incurred pursuant to the election under section 217(d)(2) and subsequently recaptured pursuant to section 217(d)(3) may be taken into account in computing the amount realized on the sale or exchange of the residence described in such subparagraph. Also, the amount of expenses described in subparagraph (B) of section 217(b)(2) deducted in the year paid or incurred pursuant to such election under section 217(d)(2) and subsequently recaptured pursuant to section 217(d)(3) may be taken into account as an adjustment to the basis of the residence described in such subparagraph.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. A was notified of his transfer effective December 15, 1972, from Seattle, WA, to Philadelphia, PA. In connection with the transfer A sold his house in Seattle on November 10, 1972. Expenses incident to the sale of the house of $2,500 were paid by A prior to or at the time of the closing of the contract of sale on December 10, 1972. The amount realized on the sale of the house was $47,500 and the adjusted basis of the house was $30,000. Pursuant to the election provided in section 217(d)(2), A deducted the expenses of moving from Seattle to Philadelphia including the expenses incident to the sale of his former residence in taxable year 1972. Dissatisfied with his position with his employer in Philadelphia, A took a position with an employer in Chicago, IL, on July 15, 1973. Since A was no longer able to satisfy the minimum period employment condition at the close of taxable year 1973 he included an amount equal to the amount deducted as moving expenses including the expenses incident to the sale of his former residence in gross income for taxable year 1973. A is permitted to decrease the amount realized on the sale of the house by the amount of the expenses incident to the sale of the house deducted from gross income and subsequently included in gross income. Thus, the amount realized on the sale of the house is decreased from $47,500 to $45,000 and thus, the gain on the sale of the house is reduced from $17,500 to $15,000. A is allowed to file an amended return or a claim for refund in order to reflect the recomputation of the amount realized.

Example 2. B, who is self-employed decided to move from Washington, DC, to Los Angeles, CA. In connection with the commencement of work in Los Angeles on March 1, 1973, B purchased a house in a suburb of Los Angeles for $65,000. Expenses incident to the purchase of the house in the amount of $1,500 were paid by B prior to or at the time of the closing of the contract of sale on September 15, 1973. Pursuant to the election provided in section 217(d)(2), B deducted the expenses of moving from Washington to Los Angeles including the expenses incident to the purchase of his new residence in taxable year 1973. Dissatisfied with his prospects in Los Angeles, B moved back to Washington on July 1, 1974. Since B was no longer able to satisfy the minimum period of employment condition at the close of taxable year 1974 he included an amount equal to the amount deducted as moving expenses incident to the purchase of the former residence in gross income for taxable year 1974. B is permitted to increase the basis of the house by the amount of the expenses incident to the purchase of the house deducted from gross income and subsequently included in gross income. Thus, the basis of the house is increased to $66,500.

(f) *Rules for self-employed individuals*—(1) *Definition.* Section 217(f)(1) defines the term *self-employed individual* for purposes of section 217 to mean an individual who performs personal services either as the owner of the entire interest in an unincorporated trade or business or as a partner in a partnership carrying on a trade or business. The term *self-employed individual* does not include the semiretired, part-time students, or other similarly situated taxpayers who work only a few hours each week. The application of this subparagraph may be illustrated by the following example:

Example. A is the owner of the entire interest in an unincorporated construction business. A hires a manager who performs all of the daily functions of the business including the negotiation of contracts with customers, the hiring and firing of employees, the purchasing of materials used on the projects, and other similar services. A and his manager discuss the operations of the business about once a week over the telephone. Otherwise A does not perform any managerial services for the business. For the purposes of section 217, A is not considered to be a self-employed individual.

(2) *Rule for application of subsection (b)(1) (C) and (D).* Section 217(f)(2) provides that for purposes of subparagraphs (C) and (D) of section 217(b)(1) an individual who commences work at a new principal place of work as a self-employed individual is treated as having obtained employment when he has made substantial arrangements to commence such work. Whether the taxpayer has made substantial arrangements to commence work at a new principal place of work is determined on the basis of all the facts and circumstances in each case. The factors to be considered in this determination depend upon the nature of the taxpayer's trade or business and include such considerations as whether the taxpayer has: (i) Leased or purchased a plant, office, shop, store, equipment, or other property to be used in the trade or business, (ii) made arrangements to purchase inventory or supplies to be used in connection with the operation of the trade or business, (iii) entered into commitments with individuals to be employed in the trade or business, and (iv) made arrangements to contact customers or clients in order to advertise the business in the general location of the new principal place of work. The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a partner in a growing chain of drug stores decided to move from Houston, TX, to Dallas, TX, in order to open a drug store in Dallas. A made several trips to Dallas for the purpose of looking for a site for the drug store. After the signing of a lease on a building in a shopping plaza, suppliers were contacted, equipment was purchased, and employees were hired. Shortly before the opening of the store A and his wife moved from Houston to Dallas and took up temporary quarters in a motel until the time their apartment was available. By the time he and his wife took up temporary quarters in the motel A was considered to have made substantial arrangements to commence work at the new principal place of work.

Example 2. B, who is a partner in a securities brokerage firm in New York, NY, decided to move to Rochester, NY, to become the resident partner in the firm's new Rochester office. After a lease was signed on an office in downtown Rochester B moved to Rochester and took up temporary quarters in a motel until his apartment became available. Before the opening of the office B supervised the decoration of the office, the purchase of equipment and supplies necessary for the operation of the office, the hiring of personnel for the office, as well as other similar activities. By the time B took up temporary quarters in the motel he was considered to have made substantial arrangements to commence to work at the new principal place of work.

Example 3. C, who is about to complete his residency in ophthalmology at a hospital in Pittsburgh, PA, decided to fly to Philadelphia, PA, for the purpose of looking into opportunities for practicing in that city. Following his arrival in Philadelphia C decided to establish his practice in that city. He leased an office and an apartment. At the time he departed Pittsburgh for Philadelphia C was not considered to have made substantial arrangements to commence work at the new principal place of work, and, therefore, is not allowed to deduct expenses described in subparagraph (C) of section 217(b)(1) (relating to expenses of traveling (including meals and lodging), after obtaining employment, from the former residence to the general location of the new principal place of work and return, for the principal purpose of searching for a new residence).

(g) *Rules for members of the Armed Forces of the United States*—(1) *In general.* The rules in paragraphs (a)(1) and (2), (b), and (e) of this section apply to moving expenses paid or incurred by members of the Armed Forces of the United States on active duty who move pursuant to a military order and incident to a permament change of station, except as provided in this paragraph (g). However, if the moving expenses are not paid or incurred incident to a permanent change of station, this paragraph (g) does not apply, but all other paragraphs of this section do apply. The provisions of this paragraph apply to taxable years beginning December 31, 1975.

(2) *Treatment of services or reimbursement provided by Government*—(i) *Services in kind.* The value of any moving or storage services furnished by the United States Government to members of the Armed Forces, their spouses, or their dependents in connection with a

permanent change of station is not includible in gross income. The Secretary of Defense and (in cases involving members of the peacetime Coast Guard) the Secretary of Transportation are not required to report or withhold taxes with respect to those services. Services furnished by the Government include services rendered directly by the Government or rendered by a third party who is compensated directly by the Government for the services.

(ii) *Reimbursements.* The following rules apply to reimbursements or allowances by the Government to members of the Armed Forces, their spouses, or their dependents for moving or storage expenses paid or incurred by them in connection with a permanent change of station. If the reimbursement or allowance exceeds the actual expenses paid or incurred, the excess is includible in the gross income of the member, and the Secretary of Defense or Secretary of Transportation must report the excess as payment of wages and withhold income taxes under section 3402 and the employee taxes under section 3102 with respect to that excess. If the reimbursement or allowance does not exceed the actual expenses, the reimbursement or allowance in not includible in gross income, and no reporting or withholding by the Secretary of Defense or Secretary of Transportation is required. If the actual expenses, as limited by paragraph (b)(9) of this section, exceed the reimbursement of allowance, the member may deduct the excess if the other requirements of this section, as modified by this paragraph, are met. The determination of the limitation on actual expenses under paragraph (b)(9) of this section is made without regard to any services in kind furnished by the Government.

(3) *Permanent change of station.* For purposes of this section, the term *permanent change of station* includes the following situations.

(i) A move from home to the first post of duty when appointed, reappointed, reinstated, or inducted.

(ii) A move from the last post of duty to home or a nearer point in the United States in connection with retirement, discharge, resignation, separation under honorable conditions, transfer, relief from active duty, temporary disability retirement, or transfer to a Fleet Reserve, if such move occurs within 1 year of such termination of active duty or within the period prescribed by the Joint Travel Regulations promulgated under the authority contained in sections 404 through 411 of title 37 of the United States Code.

(iii) A move from one permanent post of duty to another permanent post of duty at a different duty station, even if the member separates from the Armed Forces immediately or shortly after the move.

The term *permanent, post of duty, duty station,* and *honorable* have the meanings given them in appropriate Department of Defense or Department of Transportation rules and regulations.

(4) *Storage expenses.* This paragraph applies to storage expenses as well as to moving expenses described in paragraph (b)(1) of this section. the term *storage expenses* means the cost of storing personal effects of members of the Armed Forces, their spouses, and their dependents.

(5) *Moves of spouses and dependents.* (i) The following special rule applies for purposes of paragraphs (b)(9) and (10) of this section, if the spouse or dependents of a member of the Armed Forces move to or from a different location than does the member. In this case, the spouse is considered to have commenced work as an employee at a new principal place of work that is within the same general location as the location to which the member moves.

(ii) The following special rule applies for purposes of this paragraph to moves by spouses or dependents of members of the Armed Forces who die, are imprisoned, or desert while on active duty. In these cases, a move to a member's place of enlistment or induction or the member's, spouse's, or dependent's home of record or nearer point in the United States is considered incident to a permanent change of station.

(6) *Disallowance of deduction.* No deduction is allowed under this section for any moving or storage expense reimbursed by an allowance that is excluded from gross income.

(h) *Special rules for foreign moves*—(1) *Increase in limitations.* In the case of a foreign move (as defined in paragraph (h)(3) of this section), paragraph (b)(6) of this section shall be applied by substituting ''90 consecutive'' for ''30 consecutive'' each time it appears. Paragraph (b)(9) (ii), (iii) and (v) of this section shall be applied by substituting ''$6,000'' for ''$3,000'' each time it appears and by substituting ''$4,500'' for ''$1,500'' each time it appears. Paragraph (b)(9)(ii) of this section shall be applied by substituting ''$5,000'' for ''$2,000'' each time it appears and by substituting ''1979'' for ''1977'' and ''1980'' for ''1978'' each time they appear in the last sentence. Paragraph (b)(9)(v) of this section shall be applied by substituting ''$2,250'' for ''$750'' each time it appears. Paragraph (b)(9)(vi) of this section does not apply.

(2) *Allowance of certain storage fees.* In the case of a foreign move, for purposes of this section, the moving expenses described in paragraph (b)(3) of this section shall include the reasonable expenses of moving household goods and personal effects to and from storage, and of storing such goods and effects for part or all of the period during which the new place of work continues to be the taxpayer's principal place of work.

(3) *Foreign move.* For purposes of this paragraph, the term *foreign move* means a move in connection with the commencement of work by the taxpayer at a new principal place of work located outside the United States. Thus, a move from the United States to a foreign country or from one foreign country to another foreign country qualifies as a foreign move. A move within a foreign country also qualifies as a foreign move. A move from a foreign country to the United States does not qualify as a foreign move.

(4) *United States.* For purposes of this paragraph, the term *United States* includes the possessions of the United States.

(5) *Effective date.* The provisions of this paragraph apply to expenses paid or incurred in taxable years beginning after December 31, 1978. The paragraph also applies to the expenses paid or incurred in the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

(i) *Allowance of deductions in case of retirees or decedents who were working abroad*—(1) *In general.* In the case of any qualified retiree moving expenses or qualified survivor moving expenses, this section (other than paragraph (h)) shall be applied to such expenses as if they were incurred in connection with the commencement of work by the taxpayer as an employee at a new principal place of work located within the United States and the limitations of paragraph (c)(4) of this section (relating to the minimum period of employment) shall not apply.

(2) *Qualified retiree moving expenses.* For purposes of this paragraph, the term *qualified retiree moving expenses* means any moving expenses which are incurred by an individual whose former principal place of work and former residence were outside the United States and which are incurred for a move to a new residence in the United States in connection with the bona fide retirement of the individual. *Bona fide retirement* means the permanent withdrawal from gainful full-time employment and self-employment. An individual who at the time of withdrawal from gainful full-time employment or self-employment, intends the withdrawal to be permanent shall be considered to be a *bona fide retiree* even though the individual ultimately resumes gainful full-time employment or self-employment. An individual's intention may be evidenced by relevant facts and circumstances which include the age and health of the individual, the customary retirement age of employees engaged in similar work, whether the individual is receiving a retirement allowance under a pension annuity, retirement or similar fund or system, and the length of time before resuming full-time employment or self-employment.

(3) *Qualified survivor moving expenses.* (i) For purposes of this paragraph, the term *qualified survivor moving expenses* means any moving expenses:

(A) Which are paid or incurred by the spouse or any dependent (as defined in section 152) of any decedent who (as of the time of his death) had a principal place of work outside the United States, and

(B) Which are incurred for a move which begins within 6 months after the death of the decedent and which is to a residence in the United States from a former residence outside the United States which (as of the time of the decedent's death) was the residence of such decedent and the individual paying or incurring the expense.

(ii) For purposes of paragraph (i)(3) (i) (B) of this section, a move begins when:

(A) The taxpayer contracts for the moving of his or her household goods and personal effects to a residence in the United States but only if the move is completed within a reasonable time thereafter;

(B) The taxpayer's household goods and personal effects are packed and in transit to a residence in the United States; or

(C) The taxpayer leaves the former residence to travel to a new place of residence in the United States.

(4) *United States*. For purposes of this paragraph, the term *United States* includes the possessions of the United States.

(5) *Effective date*. The provisions of this paragraph apply to expenses paid or incurred in taxable years beginning after December 31, 1978. The paragraph also applies to the expenses paid or incurred in the taxable year beginning during 1978 of taxpayers who do not make an election pursuant to section 209(c) of the Foreign Earned Income Act of 1978 (Pub. L. 95–615, 92 Stat. 3109) to have section 911 under prior law apply to that taxable year.

(j) *Effective date*—(1) *In general*. This section, except as provided in subparagraphs (2) and (3) of this paragraph, is applicable to items paid or incurred in taxable years beginning after December 31, 1969.

(2) *Reimbursement not included in gross income*. This section does not apply to items to the extent that the taxpayer received or accrued in a taxable year beginning before January 1, 1970, a reimbursement or other expense allowance for such items which was not included in his gross income.

(3) *Election in cases of expenses paid or incurred before January 1, 1971, in connection with certain moves*—(i) *In general*. A taxpayer who was notified by his employer on or before December 19, 1969, of a transfer to a new principal place of work and who pays or incurs moving expenses after December 31, 1969, but before January 1, 1971, in connection with such transfer may elect to have the rules governing moving expenses in effect prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577) govern such expenses. If such election is made, this section and section 82 and the regulations thereunder do not apply to such expenses. A taxpayer is considered to have been notified on or before December 19, 1969, by his employer of a transfer, for example, if before such date the employer has sent a notice to all employees or a reasonably defined group of employees, which includes such taxpayer, of a relocation of the operations of such employer from one plant or facility to another plant or facility. An employee who is transferred to a new principal place of work for the benefit of his employer and who makes an election under this paragraph is permitted to exclude amounts received or accrued, directly or indirectly, as payment for or reimbursement of expenses of moving household goods and personal effects from the former residence to the new residence and of traveling (including meals and lodging) from the former residence to the new place of residence. Such exclusion is limited to amounts received or accrued, directly or indirectly, as a payment for or reimbursement of the expenses described above. Amounts in excess of actual expenses paid or incurred must be included in gross income. No deduction is allowable under section 217 for expenses representing amounts excluded from gross income. Also, an employee who is transferred to a new principal place of work which is less than 50 miles but at least 20 miles farther from his former residence than was his former principal place of work and who is not reimbursed, either directly or indirectly, for the expenses described above is permitted to deduct such expenses providing all of the requirements of section 217 and the regulations thereunder prior to the effective date of section 231 of the Tax Reform Act of 1969 (83 Stat. 577) are satisfied.

(ii) *Election made before the date of publication of this notice as a Treasury decision.* An election under this subparagraph made before the date of publication of this notice as a Treasury decision shall be made pursuant to the procedure prescribed in temporary income tax regulations relating to treatment of payments of expenses of moving from one residence to another residence (Part 13 of this chapter) T.D. 7032 (35 FR 4330), approved Mar. 11, 1970.

(iii) *Election made on or after the date of publication of this notice as a Treasury decision.* An election made under this subparagraph on or after the date of publication of this notice as a Treasury decision shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the year in which the expenses were paid or 30 days after the date of publication of this notice as a Treasury decision, whichever occurs last. The election shall be made by a statement attached to the return (or the amended return) for the taxable year, setting forth the following information:

(*a*) The items to which the election relates;

(*b*) The amount of each item;

(*c*) The date each item was paid or incurred; and

(*d*) The date the taxpayer was informed by his employer of his transfer to the new principal place of work.

(iv) *Revocation of election.* An election made in accordance with this subparagraph is revocable upon the filing by the taxpayer of an amended return or a claim for refund with the district director, or the director of the Internal Revenue service center with whom the election was filed not later than the time prescribed by law, including extensions thereof, for the filing of a claim for refund with respect to the items to which the election relates.

[T.D. 7195, 37 FR 13535, July 11, 1972, 37 FR 14230, July 18, 1972, as amended by T.D. 7578 43 FR 59355, Dec. 20, 1978; T.D. 7605, 44 FR 18970, Mar. 30, 1979; T.D. 7689, 45 FR 20796, Mar. 31, 1980; T.D. 7810, 47 FR 6003, Feb. 10, 1982; T.D. 8607, 60 FR 40077, Aug. 7, 1995]

§ 1.219–1 Deduction for retirement savings.

(a) *In general.* Subject to the limitations and restrictions of paragraph (b) and the special rules of paragraph (c)(3) of this section, there shall be allowed a deduction under section 62 from gross income of amounts paid for the taxable year of an individual on behalf of such individual to an individual retirement account described in section 408(a), for an individual retirement annuity described in section 408(b), or for a retirement bond described in section 409. The deduction described in the preceding sentence shall be allowed only to the individual on whose behalf such individual retirement account, individual retirement annuity, or retirement bond is maintained. The first sentence of this paragraph shall apply only in the case of a contribution of cash. A contribution of property other than cash is not allowable as a deduction under this section. In the case of a retirement bond, a deduction will not be allowed if the bond is redeemed within 12 months of its issue date.

(b) *Limitations and restrictions*—(1) *Maximum deduction.* The amount allowable as a deduction under section 219(a) to an individual for any taxable year cannot exceed an amount equal to 15 percent of the compensation includible in the gross income of the individual for such taxable year, or $1,500, whichever is less.

(2) *Restrictions*—(i) *Individuals covered by certain other plans.* No deduction is allowable under section 219(a) to an individual for the taxable year if for any part of such year:

(A) He was an active participant in:

(*1*) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a),

(*2*) An annuity plan described in section 403(a),

(*3*) A qualified bond purchase plan described in section 405(a), or

(*4*) A retirement plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, or

(B) Amounts were contributed by his employer for an annuity contract described in section 403(b) (whether or not the individual's rights in such contract are nonforfeitable).

(ii) *Contributions after age 70½.* No deduction is allowable under section 219 (a) to an individual for the taxable year of the individual, if he has attained the age of 70½ before the close of such taxable year.

(iii) *Rollover contributions.* No deduction is allowable under section 219 for any taxable year of an individual with respect to a rollover contribution described in section 402(a)(5), 402(a)(7), 403(a)(4), 403(b)(8), 408(d)(3), or 409(b)(3)(C).

(3) *Amounts contributed under endowment contracts.* (i) For any taxable year, no deduction is allowable under section 219(a) for amounts paid under an endowment contract described in §1.408–3(e) which is allocable under subdivision (ii) of this subparagraph to the cost of life insurance.

(ii) For any taxable year, the cost of current life insurance protection under an endowment contract described in paragraph (b)(3)(i) of this section is the product of the net premium cost, as determined by the Commissioner, and the excess, if any, of the death benefit payable under the contract during the policy year beginning in the taxable year over the cash value of the contract at the end of such policy year.

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

Example 1. A, an individual who is otherwise entitled to the maximum deduction allowed under section 219, purchases, at age 20, an endowment contract described in §1.408–3(e) which provides for the payment of an annuity of $100 per month, at age 65, with a minimum death benefit of $10,000, and an annual premium of $220. The cash value at the end of the first policy year is 0. The net premium cost, as determined by the Commissioner, for A's age is $1.61 per thousand dollars of life insurance protection. The cost of current life insurance protection is $16.10 ($1.61 × 10). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the first policy year begins is $203.90 ($220 − $16.10).

Example 2. Assume the same facts as in *Example 1,* except that the cash value at the end of the second policy year is $200 and the net premium cost is $1.67 per thousand for A's age. The cost of current life insurance protection is $16.37 ($1.67 × 9.8). A's maximum deduction under section 219 with respect to amounts paid under the endowment contract for the taxable year in which the second policy year begins is $203.63 ($220 − $16.37).

(c) *Definitions and special rules*—(1) *Compensation.* For purposes of this section, the term *compensation* means wages, salaries, professional fees, or other amounts derived from or received for personal service actually rendered (including, but not limited to, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, and bonuses) and includes earned income, as defined in section 401 (c) (2), but does not include amounts derived from or received as earnings or profits from property (including, but not limited to, interest and dividends) or amounts not includible in gross income.

(2) *Active participant.* For the definition of active participant, see §1.219–2.

(3) *Special rules.* (i) The maximum deduction allowable under section 219(b)(1) is computed separately for each individual. Thus, if a husband and wife each has compensation of $10,000 for the taxable year and they are each otherwise eligible to contribute to an individual retirement account and they file a joint return, then the maximum amount allowable as a deduction under section 219 is $3,000, the sum of the individual maximums of $1,500. However, if, for example, the husband has compensation of $20,000, the wife has no compensation, each is otherwise eligible to contribute to an individual retirement account for the taxable year, and they file a joint return, the maximum amount allowable as a deduction under section 219 is $1,500.

(ii) Section 219 is to be applied without regard to any community property laws. Thus, if, for example, a husband and wife, who are otherwise eligible to contribute to an individual retirement account, live in a community property jurisdiction and the husband alone has compensation of $20,000 for the taxable year, then the maximum amount allowable as a deduction under section 219 is $1,500.

(4) *Employer contributions.* For purposes of this chapter, any amount paid

by an employer to an individual retirement account or for an individual retirement annuity or retirement bond constitutes the payment of compensation to the employee (other than a self-employed individual who is an employee within the meaning of section 401(c)(1)) includible in his gross income, whether or not a deduction for such payment is allowable under section 219 to such employee after the application of section 219(b). Thus, an employer will be entitled to a deduction for compensation paid to an employee for amounts the employer contributes on the employee's behalf to an individual retirement account, for an individual retirement annuity, or for a retirement bond if such deduction is otherwise allowable under section 162.

[T.D. 7714, 45 FR 52788, Aug. 8, 1980]

§ 1.219–2 Definition of active participant.

(a) *In general.* This section defines the term *active participant* for individuals who participate in retirement plans described in section 219(b)(2). Any individual who is an active participant in such a plan is not allowed a deduction under section 219(a) for contributions to an individual retirement account.

(b) *Defined benefit plans*—(1) *In general.* Except as provided in subparagraphs (2), (3) and (4) of this paragraph, an individual is an active participant in a defined benefit plan if for any portion of the plan year ending with or within such individual's taxable year he is not excluded under the eligibility provisions of the plan. An individual is not an active participant in a particular taxable year merely because the individual meets the plan's eligibility requirements during a plan year beginning in that particular taxable year but ending in a later taxable year of the individual. However, for purposes of this section, an individual is deemed not to satisfy the eligibility provisions for a particular plan year if his compensation is less than the minimum amount of compensation needed under the plan to accrue a benefit. For example, assume a plan is integrated with Social Security and only those individuals whose compensation exceeds a certain amount accrue benefits under the plan. An individual whose compensation for the plan year ending with or within his taxable year is less than the amount necessary under the plan to accrue a benefit is not an active participant in such plan.

(2) *Rules for plans maintained by more than one employer.* In the case of a defined benefit plan described in section 413(a) and funded at least in part by service-related contributions, *e.g.*, so many cents-per-hour, an individual is an active participant if an employer is contributing or is required to contribute to the plan an amount based on that individual's service taken into account for the plan year ending with or within the individual's taxable year. The general rule in paragraph (b)(1) of this section applies in the case of plans described in section 413(a) and funded only on some non-service-related unit, *e.g.*, so many cents-per-ton of coal.

(3) *Plans in which accruals for all participants have ceased.* In the case of a defined benefit plan in which accruals for all participants have ceased, an individual in such a plan is not an active participant. However, any benefit that may vary with future compensation of an individual provides additional accruals. For example, a plan in which future benefit accruals have ceased, but the actual benefit depends upon final average compensation will not be considered as one in which accruals have ceased.

(4) *No accruals after specified age.* An individual in a defined benefit plan who accrues no additional benefits in a plan year ending with or within such individual's taxable year by reason of attaining a specified age is not an active participant by reason of his participation in that plan.

(c) *Money purchase plan.* An individual is an active participant in a money purchase plan if under the terms of the plan employer contributions must be allocated to the individual's account with respect to the plan year ending with or within the individual's taxable year. This rule applies even if an individual is not employed at any time during the individual's taxable year.

(d) *Profit-sharing and stock-bonus plans*—(1) *In general.* This paragraph applies to profit-sharing and stock bonus plans. An individual is an active participant in such plans in a taxable year if a forfeiture is allocated to his account as of a date in such taxable year. An individual is also an active participant in a taxable year in such plans if an employer contribution is added to the participant's account in such taxable year. A contribution is added to a participant's account as of the later of the following two dates: the date the contribution is made or the date as of which it is allocated. Thus, if a contribution is made in an individual's taxable year 2 and allocated as of a date in individual's taxable year 1, the later of the relevant dates is the date the contribution is made. Consequently, the individual is an active participant in year 2 but not in year 1 as a result of that contribution.

(2) *Special rule.* An individual is not an active participant for a particular taxable year by reason of a contribution made in such year allocated to a previous year if such individual was an active participant in such previous year by reason of a prior contribution that was allocated as of a date in such previous year.

(e) *Employee contributions.* If an employee makes a voluntary or mandatory contribution to a plan described in paragraphs (b), (c), or (d) of this section, such employee is an active participant in the plan for the taxable year in which such contribution is made.

(f) *Certain individuals not active participants.* For purposes of this section, an individual is not an active participant under a plan for any taxable year of such individual for which such individual elects, pursuant to the plan, not to participate in such plan.

(g) *Retirement savings for married individuals.* The provisions of this section apply in determining whether an individual or his spouse is an active participant in a plan for purposes of section 220 (relating to retirement savings for certain married individuals).

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

Example 1. The X Corporation maintains a defined benefit plan which has the following rules on participation and accrual of benefits. Each employee who has attained the age of 25 or has completed one year of service is a participant in the plan. The plan further provides that each participant shall receive upon retirement $12 per month for each year of service in which the employee completes 1,000 hours of service. The plan year is the calendar year. B, a calendar-year taxpayer, enters the plan on January 2, 1980, when he is 27 years of age. Since B has attained the age of 25, he is a participant in the plan. However, B completes less than 1,000 hours of service in 1980 and 1981. Although B is not accruing any benefits under the plan in 1980 and 1981, he is an active participant under section 219(b)(2) because he is a participant in the plan. Thus, B cannot make deductible contributions to an individual retirement arrangement for his taxable years of 1980 and 1981.

Example 2. The Y Corporation maintains a profit-sharing plan for its employees. The plan year of the plan is the calendar year. C is a calendar-year taxpayer and a participant in the plan. On June 30, 1980, the employer makes a contribution for 1980 which as allocated on July 31, 1980. In 1981 the employer makes a second contribution for 1980, allocated as of December 31, 1980. Under the general rule stated in §1.219–2(d)(1), C is an active participant in 1980. Under the special rule stated in §1.219–2(d)(2), however, C is not an active participant in 1981 by reason of that contribution made in 1981.

(i) *Effective date.* The provisions set forth in this section are effective for taxable years beginning after December 31, 1978.

[T.D. 7714, 45 FR 52789, Aug. 8, 1980]

§ 1.221–1 Deduction for interest paid on qualified education loans after December 31, 2001.

(a) *In general*—(1) *Applicability.* Under section 221, an individual taxpayer may deduct from gross income certain interest paid by the taxpayer during the taxable year on a qualified education loan. See paragraph (b)(4) of this section for rules on payments of interest by third parties. The rules of this section are applicable to periods governed by section 221 as amended in 2001, which relates to deductions for interest paid on qualified education loans after December 31, 2001, in taxable years ending after December 31, 2001, and on or before December 31, 2010. For rules applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002, see §1.221–2. Taxpayers also may apply §1.221–2 to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. To the extent that the effective date limitation (sunset) of the 2001 amendment remains in force unchanged, section 221 before amendment in 2001, to which §1.221–2 relates, also applies to interest due and paid on qualified education loans in taxable years beginning after December 31, 2010.

(2) *Example*. The following example illustrates the rules of this paragraph (a). In the example, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The example is as follows:

Example. Effective dates. Student A begins to make monthly interest payments on her loan beginning January 1, 1997. Student A continues to make interest payments in a timely fashion. However, under the effective date provisions of section 221, no deduction is allowed for interest Student A pays prior to January 1, 1998. Student A may deduct interest due and paid on the loan after December 31, 1997. Student A may apply the rules of §1.221–2 to interest due and paid during the period beginning January 1, 1998, and ending January 20, 1999. Interest due and paid during the period January 21, 1999, and ending December 31, 2001, is deductible under the rules of §1.221–2, and interest paid after December 31, 2001, is deductible under the rules of this section.

(b) *Eligibility*—(1) *Taxpayer must have a legal obligation to make interest payments*. A taxpayer is entitled to a deduction under section 221 only if the taxpayer has a legal obligation to make interest payments under the terms of the qualified education loan.

(2) *Claimed dependents not eligible*—(i) *In general*. An individual is not entitled to a deduction under section 221 for a taxable year if the individual is a dependent (as defined in section 152) for whom another taxpayer is allowed a deduction under section 151 on a Federal income tax return for the same taxable year (or, in the case of a fiscal year taxpayer, the taxable year beginning in the same calendar year as the individual's taxable year).

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

Example 1. Student not claimed as dependent. Student B pays $750 of interest on qualified education loans during 2003. Student B's parents are not allowed a deduction for her as a dependent for 2003. Assuming fulfillment of all other relevant requirements, Student B may deduct under section 221 the $750 of interest paid in 2003.

Example 2. Student claimed as dependent. Student C pays $750 of interest on qualified education loans during 2003. Only Student C has the legal obligation to make the payments. Student C's parent claims him as a dependent and is allowed a deduction under section 151 with respect to Student C in computing the parent's 2003 Federal income tax. Student C is not entitled to a deduction under section 221 for the $750 of interest paid in 2003. Because Student C's parent was not legally obligated to make the payments, Student C's parent also is not entitled to a deduction for the interest.

(3) *Married taxpayers*. If a taxpayer is married as of the close of a taxable year, he or she is entitled to a deduction under this section only if the taxpayer and the taxpayer's spouse file a joint return for that taxable year.

(4) *Payments of interest by a third party*—(i) *In general*. If a third party who is not legally obligated to make a payment of interest on a qualified education loan makes a payment of interest on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest.

(ii) *Examples*. The following examples illustrate the rules of this paragraph (b)(4):

Example 1. Payment by employer. Student D obtains a qualified education loan to attend college. Upon Student D's graduation from college, Student D works as an intern for a non-profit organization during which time Student D's loan is in deferment and Student D makes no interest payments. As part of the internship program, the non-profit organization makes an interest payment on behalf of Student D after the deferment period. This payment is not excluded from Student D's income under section 108(f) and is treated as additional compensation includible in Student D's gross income. Assuming fulfillment of all other requirements of section 221, Student D may deduct this payment of interest for Federal income tax purposes.

Example 2. Payment by parent. Student E obtains a qualified education loan to attend college. Upon graduation from college, Student E makes legally required monthly payments of principal and interest. Student E's mother makes a required monthly payment of interest as a gift to Student E. A deduction for Student E as a dependent is not allowed on another taxpayer's tax return for that taxable year. Assuming fulfillment of all other requirements of section 221, Student E may deduct this payment of interest for Federal income tax purposes.

(c) *Maximum deduction.* The amount allowed as a deduction under section 221 for any taxable year may not exceed $2,500.

(d) *Limitation based on modified adjusted gross income*—(1) *In general.* The deduction allowed under section 221 is phased out ratably for taxpayers with modified adjusted gross income between $50,000 and $65,000 ($100,000 and $130,000 for married individuals who file a joint return). Section 221 does not allow a deduction for taxpayers with modified adjusted gross income of $65,000 or above ($130,000 or above for married individuals who file a joint return). See paragraph (d)(3) of this section for inflation adjustment of amounts in this paragraph (d)(1).

(2) *Modified adjusted gross income defined.* The term *modified adjusted gross income* means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain United States possessions or Puerto Rico). Modified adjusted gross income must be determined under this section after taking into account the inclusions, exclusions, deductions, and limitations provided by sections 86 (social security and tier 1 railroad retirement benefits), 135 (redemption of qualified United States savings bonds), 137 (adoption assistance programs), 219 (deductible qualified retirement contributions), and 469 (limitation on passive activity losses and credits), but before taking into account the deductions provided by sections 221 and 222 (qualified tuition and related expenses).

(3) *Inflation adjustment.* For taxable years beginning after 2002, the amounts in paragraph (d)(1) of this section will be increased for inflation occurring after 2001 in accordance with section 221(f)(1). If any amount adjusted under section 221(f)(1) is not a multiple of $5,000, the amount will be rounded to the next lowest multiple of $5,000.

(e) *Definitions*—(1) *Eligible educational institution.* In general, an *eligible educational institution* means any college, university, vocational school, or other postsecondary educational institution described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), as in effect on August 5, 1997, and certified by the U.S. Department of Education as eligible to participate in student aid programs administered by the Department, as described in section 25A(f)(2) and §1.25A–2(b). For purposes of this section, an eligible educational institution also includes an institution that conducts an internship or residency program leading to a degree or certificate awarded by an institution, a hospital, or a health care facility that offers postgraduate training.

(2) *Qualified higher education expenses*—(i) *In general. Qualified higher education expenses* means the cost of attendance (as defined in section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087ll, as in effect on August 4, 1997), at an eligible educational institution, reduced by the amounts described in paragraph (e)(2)(ii) of this section. Consistent with section 472 of the Higher Education Act of 1965, a student's cost of attendance is determined by the eligible educational institution and includes tuition and fees normally assessed a student carrying the same academic workload as the student, an allowance for room and board, and an allowance for books, supplies, transportation, and miscellaneous expenses of the student.

(ii) *Reductions.* Qualified higher education expenses are reduced by any amount that is paid to or on behalf of a student with respect to such expenses and that is—

(A) A qualified scholarship that is excludable from income under section 117;

(B) An educational assistance allowance for a veteran or member of the armed forces under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(C) Employer-provided educational assistance that is excludable from income under section 127;

(D) Any other amount that is described in section 25A(g)(2)(C) (relating to amounts excludable from gross income as educational assistance);

(E) Any otherwise includible amount excluded from gross income under section 135 (relating to the redemption of United States savings bonds);

(F) Any otherwise includible amount distributed from a Coverdell education savings account and excluded from gross income under section 530(d)(2); or

(G) Any otherwise includible amount distributed from a qualified tuition program and excluded from gross income under section 529(c)(3)(B).

(3) *Qualified education loan*—(i) *In general.* A *qualified education loan* means indebtedness incurred by a taxpayer solely to pay qualified higher education expenses that are—

(A) Incurred on behalf of a student who is the taxpayer, the taxpayer's spouse, or a dependent (as defined in section 152) of the taxpayer at the time the taxpayer incurs the indebtedness;

(B) Attributable to education provided during an academic period, as described in section 25A and the regulations thereunder, when the student is an eligible student as defined in section 25A(b)(3) (requiring that the student be a degree candidate carrying at least half the normal full-time workload); and

(C) Paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness.

(ii) *Reasonable period.* Except as otherwise provided in this paragraph (e)(3)(ii), what constitutes a reasonable period of time for purposes of paragraph (e)(3)(i)(C) of this section generally is determined based on all the relevant facts and circumstances. However, qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness if—

(A) The expenses are paid with the proceeds of education loans that are part of a Federal postsecondary education loan program; or

(B) The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of that academic period and ends 90 days after the end of that academic period.

(iii) *Related party.* A qualified education loan does not include any indebtedness owed to a person who is related to the taxpayer, within the meaning of section 267(b) or 707(b)(1). For example, a parent or grandparent of the taxpayer is a related person. In addition, a qualified education loan does not include a loan made under any qualified employer plan as defined in section 72(p)(4) or under any contract referred to in section 72(p)(5).

(iv) *Federal issuance or guarantee not required.* A loan does not have to be issued or guaranteed under a Federal postsecondary education loan program to be a qualified education loan.

(v) *Refinanced and consolidated indebtedness*—(A) *In general.* A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.

(B) *Treatment of refinanced and consolidated indebtedness.* [Reserved]

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. Eligible educational institution. University F is a postsecondary educational institution described in section 481 of the Higher Education Act of 1965. The U.S. Department of Education has certified that University F is eligible to participate in federal financial aid programs administered by that Department, although University F chooses not to participate. University F is an eligible educational institution.

Example 2. Qualified higher education expenses. Student G receives a $3,000 qualified scholarship for the 2003 fall semester that is excludable from Student G's gross income under section 117. Student G receives no other forms of financial assistance with respect to the 2003 fall semester. Student G's cost of attendance for the 2003 fall semester, as determined by Student G's eligible educational institution for purposes of calculating a student's financial need in accordance with section 472 of the Higher Education Act, is $16,000. For the 2003 fall semester, Student G has qualified higher education expenses of $13,000 (the cost of attendance as determined by the institution ($16,000) reduced by the qualified scholarship proceeds excludable from gross income ($3,000)).

Example 3. Qualified education loan. Student H borrows money from a commercial bank to pay qualified higher education expenses related to his enrollment on a half-time basis in a graduate program at an eligible educational institution. Student H uses all the loan proceeds to pay qualified higher education expenses incurred within a reasonable period of time after incurring the indebtedness. The loan is not federally guaranteed. The commercial bank is not related to Student H within the meaning of section 267(b) or 707(b)(1). Student H's loan is a qualified education loan within the meaning of section 221.

Example 4. Qualified education loan. Student I signs a promissory note for a loan on August 15, 2003, to pay for qualified higher education expenses for the 2003 fall and 2004 spring semesters. On August 20, 2003, the lender disburses loan proceeds to Student I's college. The college credits them to Student I's account to pay qualified higher education expenses for the 2003 fall semester, which begins on August 25, 2003. On January 26, 2004, the lender disburses additional loan proceeds to Student I's college. The college credits them to Student I's account to pay qualified higher education expenses for the 2004 spring semester, which began on January 12, 2004. Student I's qualified higher education expenses for the two semesters are paid within a reasonable period of time, as the first loan disbursement occurred within the 90 days prior to the start of the fall 2003 semester and the second loan disbursement occurred during the spring 2004 semester.

Example 5. Qualified education loan. The facts are the same as in *Example 4* except that in 2005 the college is not an eligible educational institution because it loses its eligibility to participate in certain federal financial aid programs administered by the U.S. Department of Education. The qualification of Student I's loan, which was used to pay for qualified higher education expenses for the 2003 fall and 2004 spring semesters, as a qualified education loan is not affected by the college's subsequent loss of eligibility.

Example 6. Mixed-use loans. Student J signs a promissory note for a loan secured by Student J's personal residence. Student J will use part of the loan proceeds to pay for certain improvements to Student J's residence and part of the loan proceeds to pay qualified higher education expenses of Student J's spouse. Because Student J obtains the loan not solely to pay qualified higher education expenses, the loan is not a qualified education loan.

(f) *Interest*—(1) *In general.* Amounts paid on a qualified education loan are deductible under section 221 if the amounts are interest for Federal income tax purposes. For example, interest includes—

(i) Qualified stated interest (as defined in §1.1273–1(c)); and

(ii) Original issue discount, which generally includes capitalized interest. For purposes of section 221, capitalized interest means any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding principal balance of the loan.

(2) *Operative rules for original issue discount*—(i) *In general.* The rules to determine the amount of original issue discount on a loan and the accruals of the discount are in sections 163(e), 1271 through 1275, and the regulations thereunder. In general, original issue discount is the excess of a loan's stated redemption price at maturity (all payments due under the loan other than qualified stated interest payments) over its issue price (the amount loaned). Although original issue discount generally is deductible as it accrues under section 163(e) and §1.163–7, original issue discount on a qualified education loan is not deductible until paid. See paragraph (f)(3) of this section to determine when original issue discount is paid.

(ii) *Treatment of loan origination fees by the borrower.* If a loan origination fee is paid by the borrower other than for property or services provided by the lender, the fee reduces the issue price of the loan, which creates original issue discount (or additional original issue discount) on the loan in an amount equal to the fee. See §1.1273–2(g). For an example of how a loan origination fee is taken into account, see *Example 2* of paragraph (f)(4) of this section.

(3) *Allocation of payments.* See §§1.446–2(e) and 1.1275–2(a) for rules on allocating payments between interest and principal. In general, these rules treat a payment first as a payment of interest to the extent of the interest that

has accrued and remains unpaid as of the date the payment is due, and second as a payment of principal. The characterization of a payment as either interest or principal under these rules applies regardless of how the parties label the payment (either as interest or principal). Accordingly, the taxpayer may deduct the portion of a payment labeled as principal that these rules treat as a payment of interest on the loan, including any portion attributable to capitalized interest or loan origination fees.

(4) *Examples.* The following examples illustrate the rules of this paragraph (f). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The examples are as follows:

Example 1. Capitalized interest. Interest on Student K's loan accrues while Student K is in school, but Student K is not required to make any payments on the loan until six months after he graduates or otherwise leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, Student K is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount. See section 1273 and the regulations thereunder. Therefore, in determining the total amount of interest paid on the loan each taxable year, Student K may deduct any payments that §1.1275–2(a) treats as payments of interest, including any principal payments that are treated as payments of capitalized interest. See paragraph (f)(3) of this section.

Example 2. Allocation of payments. The facts are the same as in *Example 1*, except that, in addition, the lender charges Student K a loan origination fee, which is not for any property or services provided by the lender. Under §1.1273–2(g), the loan origination fee reduces the issue price of the loan, which reduction increases the amount of original issue discount on the loan by the amount of the fee. The amount of original issue discount (which includes the capitalized interest and loan origination fee) that accrues each year is determined under section 1272 and §1.1272–1. In effect, the loan origination fee accrues over the entire term of the loan. Because the loan has original issue discount, the payment ordering rules in §1.1275–2(a) must be used to determine how much of each payment is interest for federal tax purposes. See paragraph (f)(3) of this section. Under §1.1275–2(a), each payment (regardless of its designation by the parties as either interest or principal) generally is treated first as a payment of original issue discount, to the extent of the original issue discount that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Therefore, in determining the total amount of interest paid on the qualified education loan for a taxable year, Student K may deduct any payments that the parties label as principal but that are treated as payments of original issue discount under §1.1275–2(a).

(g) *Additional Rules*—(1) *Payment of interest made during period when interest payment not required.* Payments of interest on a qualified education loan to which this section is applicable are deductible even if the payments are made during a period when interest payments are not required because, for example, the loan has not yet entered repayment status or is in a period of deferment or forbearance.

(2) *Denial of double benefit.* No deduction is allowed under this section for any amount for which a deduction is allowable under another provision of Chapter 1 of the Internal Revenue Code. No deduction is allowed under this section for any amount for which an exclusion is allowable under section 108(f) (relating to cancellation of indebtedness).

(3) *Examples.* The following examples illustrate the rules of this paragraph (g). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, and the student is legally obligated to make interest payments under the terms of the loan:

Example 1. Voluntary payment of interest before loan has entered repayment status. Student L obtains a loan to attend college. The terms of the loan provide that interest accrues on the loan while Student L earns his undergraduate degree but that Student L is not required to begin making payments of interest until six full calendar months after he graduates or otherwise leaves school. Nevertheless, Student L voluntarily pays interest on the loan during 2003, while enrolled in college. Assuming all other relevant requirements are met, Student L is allowed a deduction for interest paid while attending college even though the payments were made before interest payments were required.

Example 2. Voluntary payment during period of deferment or forbearance. The facts are the same as in *Example 2,* except that Student L makes no payments on the loan while enrolled in college. Student L graduates in June 2003 and begins making monthly payments of principal and interest on the loan in January 2004, as required by the terms of the loan. In August 2004, Student L enrolls in graduate school on a full-time basis. Under the terms of the loan, Student L may apply for deferment of the loan payments while Student L is enrolled in graduate school. Student L applies for and receives a deferment on the outstanding loan. However, Student L continues to make some monthly payments of interest during graduate school. Student L may deduct interest paid on the loan during the period beginning in January 2004, including interest paid while Student L is enrolled in graduate school.

(h) *Effective date.* This section is applicable to periods governed by section 221 as amended in 2001, which relates to interest paid on a qualified education loan after December 31, 2001, in taxable years ending after December 31, 2001, and on or before December 31, 2010.

[T.D. 9125, 69 FR 25492, May 7, 2004]

§ 1.221–2 Deduction for interest due and paid on qualified education loans before January 1, 2002.

(a) *In general.* Under section 221, an individual taxpayer may deduct from gross income certain interest due and paid by the taxpayer during the taxable year on a qualified education loan. The deduction is allowed only with respect to interest due and paid on a qualified education loan during the first 60 months that interest payments are required under the terms of the loan. See paragraph (e) of this section for rules relating to the 60-month rule. See paragraph (b)(4) of this section for rules on payments of interest by third parties. The rules of this section are applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002. Taxpayers also may apply the rules of this section to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. To the extent that the effective date limitation (''sunset'') of the 2001 amendment remains in force unchanged, section 221 before amendment in 2001, to which this section relates, also applies to interest due and paid on qualified education loans in taxable years beginning after December 31, 2010. For rules applicable to periods governed by section 221 as amended in 2001, which relates to deductions for interest paid on qualified education loans after December 31, 2001, in taxable years ending after December 31, 2001, and before January 1, 2011, see § 1.221–1.

(b) *Eligibility*—(1) *Taxpayer must have a legal obligation to make interest payments.* A taxpayer is entitled to a deduction under section 221 only if the taxpayer has a legal obligation to make interest payments under the terms of the qualified education loan.

(2) *Claimed dependents not eligible*—(i) *In general.* An individual is not entitled to a deduction under section 221 for a taxable year if the individual is a dependent (as defined in section 152) for whom another taxpayer is allowed a deduction under section 151 on a Federal income tax return for the same taxable year (or, in the case of a fiscal year taxpayer, the taxable year beginning in the same calendar year as the individual's taxable year).

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

Example 1. Student not claimed as dependent. Student A pays $750 of interest on qualified education loans during 1998. Student A's parents are not allowed a deduction for her as a dependent for 1998. Assuming fulfillment of all other relevant requirements, Student A may deduct the $750 of interest paid in 1998 under section 221.

Example 2. Student claimed as dependent. Student B pays $750 of interest on qualified education loans during 1998. Only Student B has the legal obligation to make the payments. Student B's parent claims him as a dependent and is allowed a deduction under section 151 with respect to Student B in computing the parent's 1998 Federal income tax. Student B may not deduct the $750 of interest paid in 1998 under section 221. Because Student B's parent was not legally obligated to make the payments, Student B's parent also may not deduct the interest.

(3) *Married taxpayers.* If a taxpayer is married as of the close of a taxable year, he or she is entitled to a deduction under this section only if the taxpayer and the taxpayer's spouse file a joint return for that taxable year.

(4) *Payments of interest by a third party*—(i) *In general.* If a third party who is not legally obligated to make a payment of interest on a qualified education loan makes a payment of interest on behalf of a taxpayer who is legally obligated to make the payment, then the taxpayer is treated as receiving the payment from the third party and, in turn, paying the interest.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (b)(4):

Example 1. Payment by employer. Student C obtains a qualified education loan to attend college. Upon Student C's graduation from college, Student C works as an intern for a non-profit organization during which time Student C's loan is in deferment and Student C makes no interest payments. As part of the internship program, the non-profit organization makes an interest payment on behalf of Student C after the deferment period. This payment is not excluded from Student C's income under section 108(f) and is treated as additional compensation includible in Student C's gross income. Assuming fulfillment of all other requirements of section 221, Student C may deduct this payment of interest for Federal income tax purposes.

Example 2. Payment by parent. Student D obtains a qualified education loan to attend college. Upon graduation from college, Student D makes legally required monthly payments of principal and interest. Student D's mother makes a required monthly payment of interest as a gift to Student D. A deduction for Student D as a dependent is not allowed on another taxpayer's tax return for that taxable year. Assuming fulfillment of all other requirements of section 221, Student D may deduct this payment of interest for Federal income tax purposes.

(c) *Maximum deduction.* In any taxable year beginning before January 1, 2002, the amount allowed as a deduction under section 221 may not exceed the amount determined in accordance with the following table:

Taxable year beginning in	Maximum deduction
1998	$1,000
1999	1,500
2000	2,000
2001	2,500

(d) *Limitation based on modified adjusted gross income*—(1) *In general.* The deduction allowed under section 221 is phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $55,000 ($60,000 and $75,000 for married individuals who file a joint return). Section 221 does not allow a deduction for taxpayers with modified adjusted gross income of $55,000 or above ($75,000 or above for married individuals who file a joint return).

(2) *Modified adjusted gross income defined.* The term *modified adjusted gross income* means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain United States possessions or Puerto Rico). Modified adjusted gross income must be determined under this section after taking into account the inclusions, exclusions, deductions, and limitations provided by sections 86 (social security and tier 1 railroad retirement benefits), 135 (redemption of qualified United States savings bonds), 137 (adoption assistance programs), 219 (deductible qualified retirement contributions), and 469 (limitation on passive activity losses and credits), but before taking into account the deduction provided by section 221.

(e) *60-month rule*—(1) *In general.* A deduction for interest paid on a qualified education loan is allowed only for payments made during the first 60 months that interest payments are required on the loan. The 60-month period begins on the first day of the month that includes the date on which interest payments are first required and ends 60 months later, unless the 60-month period is suspended for periods of deferment or forbearance within the meaning of paragraph (e)(3) of this section. The 60-month period continues to run regardless of whether the required interest payments are actually made. The date on which the first interest payment is required is determined under the terms of the loan agreement or, in the case of a loan issued or guaranteed under a federal postsecondary education loan program (such as loan programs under title IV of the Higher Education Act of 1965 (20 U.S.C. 1070) and titles VII and VIII of the Public Health Service Act (42 U.S.C. 292., and 42 U.S.C. 296)) under applicable Federal regulations. For a discussion of interest, see paragraph (h) of this section.

For special rules relating to loan refinancings, consolidated loans, and collapsed loans, see paragraph (i) of this section.

(2) *Loans that entered repayment status prior to January 1, 1998.* In the case of any qualified education loan that entered repayment status prior to January 1, 1998, section 221 allows no deduction for interest paid during the portion of the 60-month period described in paragraph (e)(1) of this section that occurred prior to January 1, 1998. Section 221 allows a deduction only for interest due and paid during that portion, if any, of the 60-month period remaining after December 31, 1997.

(3) *Periods of deferment or forbearance.* The 60-month period described in paragraph (e)(1) of this section generally is suspended for any period when interest payments are not required on a qualified education loan because the lender has granted the taxpayer a period of deferment or forbearance (including postponement in anticipation of cancellation). However, in the case of a qualified education loan that is not issued or guaranteed under a Federal postsecondary education loan program, the 60-month period will be suspended under this paragraph (e)(3) only if the promissory note contains conditions substantially similar to the conditions for deferment or forbearance established by the U.S. Department of Education for Federal student loan programs under title IV of the Higher Education Act of 1965, such as half-time study at a postsecondary educational institution, study in an approved graduate fellowship program or in an approved rehabilitation program for the disabled, inability to find full-time employment, economic hardship, or the performance of services in certain occupations or federal programs, and the borrower satisfies one of those conditions. For any qualified education loan, the 60-month period is not suspended if under the terms of the loan interest continues to accrue while the loan is in deferment or forbearance and either—

(i) In the case of deferment, the taxpayer agrees to pay interest currently during the deferment period; or

(ii) In the case of forbearance, the taxpayer agrees to make reduced payments, or payments of interest only, during the forbearance period.

(4) *Late payments.* A deduction is allowed for a payment of interest required in one month but actually made in a subsequent month prior to the expiration of the 60-month period. A deduction is not allowed for a payment of interest required in one month but actually made in a subsequent month after the expiration of the 60-month period. A late payment made during a period of deferment or forbearance is treated, solely for purposes of determining whether it is made during the 60-month period, as made on the date it is due.

(5) *Examples.* The following examples illustrate the rules of this paragraph (e). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan and is issued or guaranteed under a federal postsecondary education loan program, the student is legally obligated to make interest payments under the terms of the loan, the interest payments occur after December 31, 1997, but before January 1, 2002, and with respect to any period after December 31, 1997, but before January 21, 1999, the taxpayer elects to apply the rules of this section. The examples are as follows:

Example 1. Payment prior to 60-month period. Student E obtains a loan to attend college. The terms of the loan provide that interest accrues on the loan while Student E earns his undergraduate degree but that Student E is not required to begin making payments of interest until six full calendar months after he graduates. Nevertheless, Student E voluntarily pays interest on the loan while attending college. Student E is not allowed a deduction for interest paid during that period, because those payments were made prior to the start of the 60-month period. Similarly, Student E would not be allowed a deduction for any interest paid during the six month grace period after graduation when interest payments are not required.

Example 2. Deferment option not exercised. The facts are the same as in *Example* 1 except that Student E makes no payments on the loan while enrolled in college. Student E graduates in June 1999, and is required to begin making monthly payments of principal and interest on the loan in January 2000. The 60-month period described in paragraph (e)(1) of this section begins in January 2000. In August 2000, Student E enrolls in graduate school on a full-time basis. Under the terms of the loan, Student E may apply for deferment of the loan payments while enrolled in graduate school. However, Student E elects not to apply for deferment and continues to make required monthly payments on the loan during graduate school. Assuming fulfillment of all other relevant requirements, Student E may deduct interest paid on the loan during the 60-month period beginning in January 2000, including interest paid while enrolled in graduate school.

Example 3. Late payment, within 60-month period. The facts are the same as in *Example 2* except that, after the loan enters repayment status in January 2000, Student E makes no interest payments until March 2000. In March 2000, Student E pays interest required for the months of January, February, and March 2000. Assuming fulfillment of all other relevant requirements, Student E may deduct the interest paid in March for the months of January, February, and March because the interest payments are required under the terms of the loan and are paid within the 60-month period, even though the January and February interest payments may be late.

Example 4. Late payment during deferment but within 60-month period. The terms of Student F's loan require her to begin making monthly payments of interest on the loan in January 2000. The 60-month period described in paragraph (e)(1) of this section begins in January 2000. Student F fails to make the required interest payments for the months of November and December 2000. In January 2001, Student F enrolls in graduate school on a half-time basis. Under the terms of the loan, Student F obtains a deferment of the loan payments due while enrolled in graduate school. The deferment becomes effective January 1, 2001. In March 2001, while the loan is in deferment, Student F pays the interest due for the months of November and December 2000. Assuming fulfillment of all other relevant requirements, Student F may deduct interest paid in March 2001, for the months of November and December 2000, because the late interest payments are treated, solely for purposes of determining whether they were made during the 60-month period, as made in November and December 2000.

Example 5. 60-month period. The terms of Student G's loan require him to begin making monthly payments of interest on the loan in November 1999. The 60-month period described in paragraph (e)(1) of this section begins in November 1999. In January 2000, Student G enrolls in graduate school on a half-time basis. As permitted under the terms of the loan, Student G applies for deferment of the loan payments due while enrolled in graduate school. While awaiting formal approval from the lender of his request for deferment, Student G pays interest due for the month of January 2000. In February 2000, the lender approves Student G's request for deferment, effective as of January 1, 2000. Assuming fulfillment of all other relevant requirements, Student G may deduct interest paid in January 2000, prior to his receipt of the lender's approval, even though the deferment was retroactive to January 1, 2000. As of February 2000, there are 57 months remaining in the 60-month period for that loan. Because Student G is not required to make interest payments during the period of deferment, the 60-month period is suspended. After January 2000, Student G may not deduct any voluntary payments of interest made during the period of deferment.

Example 6. 60-month period. The terms of Student H's loan require her to begin making monthly payments of interest on the loan in November 1999. The 60-month period described in paragraph (e)(1) of this section begins in November 1999. In January 2000, Student H enrolls in graduate school on a half-time basis. As permitted under the terms of the loan, Student H applies to make reduced payments of principal and interest while enrolled in graduate school. After the lender approves her application, Student H pays principal and interest due for the month of January 2000 at the reduced rate. Assuming fulfillment of all other relevant requirements, Student H may deduct interest paid in January 2000. As of February 2000, there are 57 months remaining in the 60-month period for that loan.

Example 7. Reduction of 60-month period for months prior to January 1, 1998. The first payment of interest on a loan is due in January 1997. Thereafter, interest payments are required on a monthly basis. The 60-month period described in paragraph (e)(1) of this section for this loan begins on January 1, 1997, the first day of the month that includes the date on which the first interest payment is required. However, the borrower may not deduct interest paid prior to January 1, 1998, under the effective date provisions of section 221. Assuming fulfillment of all other relevant requirements, the borrower may deduct interest due and paid on the loan during the 48 months beginning on January 1, 1998 (unless such period is extended for periods of deferment or forbearance under paragraph (e)(3) of this section).

(f) *Definitions*—(1) *Eligible educational institution.* In general, an *eligible educational institution* means any college, university, vocational school, or other post-secondary educational institution described in section 481 of the Higher Education Act of 1965, 20 U.S.C. 1088, as in effect on August 5, 1997, and certified by the U.S. Department of Education as eligible to participate in student aid programs administered by the Department, as described in section 25A(f)(2) and §1.25A–2(b). For purposes of this section, an eligible educational institution also includes an institution that conducts an internship or residency program leading to a degree or certificate awarded by an institution, a hospital, or a health care facility that offers postgraduate training.

(2) *Qualified higher education expenses*—(i) *In general. Qualified higher education expenses* means the cost of attendance (as defined in section 472 of the Higher Education Act of 1965, 20 U.S.C. 1087ll, as in effect on August 4, 1997), at an eligible educational institution, reduced by the amounts described in paragraph (f)(2)(ii) of this section. Consistent with section 472 of the Higher Education Act of 1965, a student's cost of attendance is determined by the eligible educational institution and includes tuition and fees normally assessed a student carrying the same academic workload as the student, an allowance for room and board, and an allowance for books, supplies, transportation, and miscellaneous expenses of the student.

(ii) *Reductions*. Qualified higher education expenses are reduced by any amount that is paid to or on behalf of a student with respect to such expenses and that is—

(A) A qualified scholarship that is excludable from income under section 117;

(B) An educational assistance allowance for a veteran or member of the armed forces under chapter 30, 31, 32, 34 or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(C) Employer-provided educational assistance that is excludable from income under section 127;

(D) Any other amount that is described in section 25A(g)(2)(C) (relating to amounts excludable from gross income as educational assistance);

(E) Any otherwise includible amount excluded from gross income under section 135 (relating to the redemption of United States savings bonds); or

(F) Any otherwise includible amount distributed from a Coverdell education savings account and excluded from gross income under section 530(d)(2).

(3) *Qualified education loan*—(i) *In general*. A *qualified education loan* means indebtedness incurred by a taxpayer solely to pay qualified higher education expenses that are—

(A) Incurred on behalf of a student who is the taxpayer, the taxpayer's spouse, or a dependent (as defined in section 152) of the taxpayer at the time the taxpayer incurs the indebtedness;

(B) Attributable to education provided during an academic period, as described in section 25A and the regulations thereunder, when the student is an eligible student as defined in section 25A(b)(3) (requiring that the student be a degree candidate carrying at least half the normal full-time workload); and

(C) Paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness.

(ii) *Reasonable period*. Except as otherwise provided in this paragraph (f)(3)(ii), what constitutes a reasonable period of time for purposes of paragraph (f)(3)(i)(C) of this section generally is determined based on all the relevant facts and circumstances. However, qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the taxpayer incurs the indebtedness if—

(A) The expenses are paid with the proceeds of education loans that are part of a federal postsecondary education loan program; or

(B) The expenses relate to a particular academic period and the loan proceeds used to pay the expenses are disbursed within a period that begins 90 days prior to the start of that academic period and ends 90 days after the end of that academic period.

(iii) *Related party*. A qualified education loan does not include any indebtedness owed to a person who is related to the taxpayer, within the meaning of section 267(b) or 707(b)(1). For example, a parent or grandparent of the taxpayer is a related person. In addition, a qualified education loan does not include a loan made under any qualified employer plan as defined in section 72(p)(4) or under any contract referred to in section 72(p)(5).

(iv) *Federal issuance or guarantee not required*. A loan does not have to be issued or guaranteed under a federal postsecondary education loan program to be a qualified education loan.

(v) *Refinanced and consolidated indebtedness*—(A) In *general.* A qualified education loan includes indebtedness incurred solely to refinance a qualified education loan. A qualified education loan includes a single, consolidated indebtedness incurred solely to refinance two or more qualified education loans of a borrower.

(B) *Treatment of refinanced and consolidated indebtedness.* [Reserved]

(4) *Examples.* The following examples illustrate the rules of this paragraph (f):

Example 1. Eligible educational institution. University J is a postsecondary educational institution described in section 481 of the Higher Education Act of 1965. The U.S. Department of Education has certified that University J is eligible to participate in federal financial aid programs administered by that Department, although University J chooses not to participate. University J is an eligible educational institution.

Example 2. Qualified higher education expenses. Student K receives a $3,000 qualified scholarship for the 1999 fall semester that is excludable from Student K's gross income under section 117. Student K receives no other forms of financial assistance with respect to the 1999 fall semester. Student K's cost of attendance for the 1999 fall semester, as determined by Student K's eligible educational institution for purposes of calculating a student's financial need in accordance with section 472 of the Higher Education Act, is $16,000. For the 1999 fall semester, Student K has qualified higher education expenses of $13,000 (the cost of attendance as determined by the institution ($16,000) reduced by the qualified scholarship proceeds excludable from gross income ($3,000)).

Example 3. Qualified education loan. Student L borrows money from a commercial bank to pay qualified higher education expenses related to his enrollment on a half-time basis in a graduate program at an eligible educational institution. Student L uses all the loan proceeds to pay qualified higher education expenses incurred within a reasonable period of time after incurring the indebtedness. The loan is not federally guaranteed. The commercial bank is not related to Student L within the meaning of section 267(b) or 707(b)(1). Student L's loan is a qualified education loan within the meaning of section 221.

Example 4. Qualified education loan. Student M signs a promissory note for a loan on August 15, 1999, to pay for qualified higher education expenses for the 1999 fall and 2000 spring semesters. On August 20, 1999, the lender disburses loan proceeds to Student M's college. The college credits them to Student M's account to pay qualified higher education expenses for the 1999 fall semester, which begins on August 23, 1999. On January 25, 2000, the lender disburses additional loan proceeds to Student M's college. The college credits them to Student M's account to pay qualified higher education expenses for the 2000 spring semester, which began on January 10, 2000. Student M's qualified higher education expenses for the two semesters are paid within a reasonable period of time, as the first loan disbursement occurred within the 90 days prior to the start of the fall 1999 semester, and the second loan disbursement occurred during the spring 2000 semester.

Example 5. Qualified education loan. The facts are the same as in *Example 4,* except that in 2001 the college is not an eligible educational institution because it loses its eligibility to participate in certain federal financial aid programs administered by the U.S. Department of Education. The qualification of Student M's loan, which was used to pay for qualified higher education expenses for the 1999 fall and 2000 spring semesters, as a qualified education loan is not affected by the college's subsequent loss of eligibility.

Example 6. Mixed-use loans. Student N signs a promissory note for a loan that is secured by Student N's personal residence. Student N will use part of the loan proceeds to pay for certain improvements to Student N's residence and part of the loan proceeds to pay qualified higher education expenses of Student N's spouse. Because Student N obtains the loan not solely to pay qualified higher education expenses, the loan is not a qualified education loan.

(g) *Denial of double benefit.* No deduction is allowed under this section for any amount for which a deduction is allowable under another provision of Chapter 1 of the Internal Revenue Code. No deduction is allowed under this section for any amount for which an exclusion is allowable under section 108(f) (relating to cancellation of indebtedness).

(h) *Interest*—(1) *In general.* Amounts paid on a qualified education loan are deductible under section 221 if the amounts are interest for Federal income tax purposes. For example, interest includes—

(i) Qualified stated interest (as defined in §1.1273–1(c)); and

(ii) Original issue discount, which generally includes capitalized interest. For purposes of section 221, capitalized interest means any accrued and unpaid interest on a qualified education loan that, in accordance with the terms of the loan, is added by the lender to the outstanding principal balance of the loan.

(2) *Operative rules for original issue discount*—(i) *In general.* The rules to determine the amount of original issue discount on a loan and the accruals of the discount are in sections 163(e), 1271 through 1275, and the regulations thereunder. In general, original issue discount is the excess of a loan's stated redemption price at maturity (all payments due under the loan other than qualified stated interest payments) over its issue price (the amount loaned). Although original issue discount generally is deductible as it accrues under section 163(e) and §1.163–7, original issue discount on a qualified education loan is not deductible until paid. See paragraph (h)(3) of this section to determine when original issue discount is paid.

(ii) *Treatment of loan origination fees by the borrower.* If a loan origination fee is paid by the borrower other than for property or services provided by the lender, the fee reduces the issue price of the loan, which creates original issue discount (or additional original issue discount) on the loan in an amount equal to the fee. See §1.1273–2(g). For an example of how a loan origination fee is taken into account, see *Example 2* of paragraph (h)(4) of this section.

(3) *Allocation of payments.* See §§1.446–2(e) and 1.1275–2(a) for rules on allocating payments between interest and principal. In general, these rules treat a payment first as a payment of interest to the extent of the interest that has accrued and remains unpaid as of the date the payment is due, and second as a payment of principal. The characterization of a payment as either interest or principal under these rules applies regardless of how the parties label the payment (either as interest or principal). Accordingly, the taxpayer may deduct the portion of a payment labeled as principal that these rules treat as a payment of interest on the loan, including any portion attributable to capitalized interest or loan origination fees.

(4) *Examples.* The following examples illustrate the rules of this paragraph (h). In the examples, assume that the institution the student attends is an eligible educational institution, the loan is a qualified education loan, the student is legally obligated to make interest payments under the terms of the loan, and any other applicable requirements, if not otherwise specified, are fulfilled. The examples are as follows:

Example 1. Capitalized interest. Interest on Student O's qualified education loan accrues while Student O is in school, but Student O is not required to make any payments on the loan until six months after he graduates or otherwise leaves school. At that time, the lender capitalizes all accrued but unpaid interest and adds it to the outstanding principal amount of the loan. Thereafter, Student O is required to make monthly payments of interest and principal on the loan. The interest payable on the loan, including the capitalized interest, is original issue discount. Therefore, in determining the total amount of interest paid on the qualified education loan during the 60-month period described in paragraph (e)(1) of this section, Student O may deduct any payments that §1.1275–2(a) treats as payments of interest, including any principal payments that are treated as payments of capitalized interest. See paragraph (h)(3) of this section.

Example 2. Allocation of payments. The facts are the same as in *Example 1* of this paragraph (h)(4), except that, in addition, the lender charges Student O a loan origination fee, which is not for any property or services provided by the lender. Under §1.1273–2(g), the loan origination fee reduces the issue price of the loan, which reduction increases the amount of original issue discount on the loan by the amount of the fee. The amount of original issue discount (which includes the capitalized interest and loan origination fee) that accrues each year is determined under section §1272 and §1.1272–1. In effect, the loan origination fee accrues over the entire term of the loan. Because the loan has original issue discount, the payment ordering rules in §1.1275–2(a) must be used to determine how much of each payment is interest for federal tax purposes. See paragraph (h)(3) of this section. Under §1.1275–2(a), each payment (regardless of its designation by the parties as either interest or principal) generally is treated first as a payment of original issue discount, to the extent of the original issue discount that has accrued as of the date the payment is due and has not been allocated to prior payments, and second as a payment of principal. Therefore, in determining the total amount of interest paid on the qualified education loan during the 60-month period described in paragraph (e)(1) of this section, Student O may deduct any payments that the parties label as principal but that are treated as payments of original issue discount under §1.1275–2(a). The 60-month period does not begin in the month in which the lender charges Student O the loan origination fee.

(i) *Special rules regarding 60-month limitation*—(1) *Refinancing.* A qualified education loan and all indebtedness incurred solely to refinance that loan constitute a single loan for purposes of calculating the 60-month period described in paragraph (e)(1) of this section.

(2) *Consolidated loans.* A consolidated loan is a single loan that refinances more than one qualified education loan of a borrower. For consolidated loans, the 60-month period described in paragraph (e)(1) of this section begins on the latest date on which any of the underlying loans entered repayment status and includes any subsequent month in which the consolidated loan is in repayment status.

(3) *Collapsed loans.* A collapsed loan is two or more qualified education loans of a single taxpayer that constitute a single qualified education loan for loan servicing purposes and for which the lender or servicer does not separately account. For a collapsed loan, the 60-month period described in paragraph (e)(1) of this section begins on the latest date on which any of the underlying loans entered repayment status and includes any subsequent month in which any of the underlying loans is in repayment status.

(4) *Examples.* The following examples illustrate the rules of this paragraph (i):

Example 1. Refinancing. Student P obtains a qualified education loan to pay for an undergraduate degree at an eligible educational institution. After graduation, Student P is required to make monthly interest payments on the loan beginning in January 2000. Student P makes the required interest payments for 15 months. In April 2001, Student P borrows money from another lender exclusively to repay the first qualified education loan. The new loan requires interest payments to start immediately. At the time Student P must begin interest payments on the new loan, which is a qualified education loan, there are 45 months remaining of the original 60-month period referred to in paragraph (e)(1) of this section.

Example 2. Collapsed loans. To finance his education, Student Q obtains four separate qualified education loans from Lender R. The loans enter repayment status, and their respective 60-month periods described in paragraph (e)(1) of this section begin, in July, August, September, and December of 1999. After all of Student Q's loans have entered repayment status, Lender R informs Student Q that Lender R will transfer all four loans to Lender S. Following the transfer, Lender S treats the loans as a single loan for loan servicing purposes. Lender S sends Student Q a single statement that shows the total principal and interest, and does not keep separate records with respect to each loan. With respect to the single collapsed loan, the 60-month period described in paragraph (e)(1) of this section begins in December 1999.

(j) *Effective date.* This section is applicable to interest due and paid on qualified education loans after January 21, 1999, if paid before January 1, 2002. Taxpayers also may apply this section to interest due and paid on qualified education loans after December 31, 1997, but before January 21, 1999. This section also applies to interest due and paid on qualified education loans in a taxable year beginning after December 31, 2010.

[T.D. 9125, 69 FR 25492, May 7, 2004]

SPECIAL DEDUCTIONS FOR CORPORATIONS

§1.241–1 Allowance of special deductions.

A corporation, in computing its taxable income, is allowed as deductions the items specified in Part VIII (section 242 and following), Subchapter B, Chapter 1 of the Code, in addition to the deductions provided in part VI (section 161 and following) Subchapter B, Chapter 1 of the Code.

§1.242–1 Deduction for partially tax-exempt interest.

A corporation is allowed a deduction under section 242(a) in an amount equal to certain interest received on obligations of the United States, or an obligation of corporations organized under Acts of Congress which are instrumentalities of the United States. The interest for which a deduction shall be allowed is interest which is included in gross income and which is exempt from normal tax under the act, as amended and supplemented, which authorized the issuance of the obligations. The deduction allowed by section 242(a) is allowed only for the purpose of computing normal tax, and therefore, no deduction is allowed for such interest in the computation of any surtax imposed by Subtitle A of the Internal Revenue Code of 1954.

[T.D. 7100, 36 FR 5333, Mar. 20, 1971]

§ 1.243–1 Deduction for dividends received by corporations.

(a)(1) A corporation is allowed a deduction under section 243 for dividends received from a domestic corporation which is subject to taxation under Chapter 1 of the Internal Revenue Code of 1954.

(2) Except as provided in section 243(c) and in section 246, the deduction is:

(i) For the taxable year, an amount equal to 85 percent of the dividends received from such domestic corporations during the taxable year (other than dividends to which subdivision (ii) or (iii) of this subparagraph applies).

(ii) For a taxable year beginning after September 2, 1958, an amount equal to 100 percent of the dividends received from such domestic corporations if at the time of receipt of such dividends the recipient corporation is a Federal licensee under the Small Business Investment Act of 1958 (15 U.S.C. ch. 14B). However, to claim the deduction provided by section 243(a)(2) the company must file with its return a statement that it was a Federal licensee under the Small Business Investment Act of 1958 at the time of the receipt of the dividends.

(iii) For a taxable year ending after December 31, 1963, an amount equal to 100 percent of the dividends received which are *qualifying dividends*, as defined in section 243(b) and § 1.243–4.

(3) To determine the amount of the distribution to a recipient corporation and the amount of the dividend, see §§ 1.301–1 and 1.316–1.

(b) For limitation on the dividends received deduction, see section 246 and the regulations thereunder.

[T.D. 6992, 34 FR 817, Jan. 18, 1969]

§ 1.243–2 Special rules for certain distributions.

(a) *Dividends paid by mutual savings banks, etc.* In determining the deduction provided in section 243(a), any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, cooperative banks, and domestic building and loan associations) shall not be considered as a dividend.

(b) *Dividends received from regulated investment companies.* In determining the deduction provided in section 243(a), dividends received from a regulated investment company shall be subject to the limitations provided in section 854.

(c) *Dividends received from real estate investment trusts.* See section 857(c) and paragraph (d) of § 1.857–6 for special rules which deny a deduction under section 243 in the case of dividends received from a real estate investment trust with respect to a taxable year for which such trust is taxable under Part II, Subchapter M, Chapter 1 of the Code.

(d) *Dividends received on preferred stock of a public utility.* The deduction allowed by section 243(a) shall be determined without regard to any dividends described in section 244 (relating to dividends on the preferred stock of a public utility). That is, such deduction shall be determined without regard to any dividends received on the preferred stock of a public utility which is subject to taxation under Chapter 1 of the Code and with respect to which a deduction is allowed by section 247 (relating to dividends paid on certain preferred stock of public utilities). For a deduction with respect to such dividends received on the preferred stock of a public utility, see section 244. If a deduction for dividends paid is not allowable to the distributing corporation under section 247 with respect to the dividends on its preferred stock, such dividends received from a domestic public utility corporation subject to taxation under Chapter 1 of the Code are includible in determining the deduction allowed by section 243(a).

[T.D. 6598, 27 FR 4092, Apr. 28, 1962, as amended by T.D. 6992, 34 FR 817, Jan. 18, 1969; T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§ 1.243–3 Certain dividends from foreign corporations.

(a) *In general.* (1) In determining the deduction provided in section 243(a), section 243(d) provides that a dividend received from a foreign corporation after December 31, 1959, shall be treated as a dividend from a domestic corporation which is subject to taxation under chapter 1 of the Code, but only to the extent that such dividend is out of earnings and profits accumulated by a domestic corporation during a period with respect to which such domestic corporation was subject to taxation under Chapter 1 of the Code (or corresponding provisions of prior law). Thus, for example, if a domestic corporation accumulates earnings and profits during a period or periods with respect to which it is subject to taxation under Chapter 1 of the Code (or corresponding provisions of prior law) and subsequently such domestic corporation reincorporates in a foreign country, any dividends paid out of such earnings and profits after such reincorporation are eligible for the deduction provided in section 243(a) (1) and (2).

(2) Section 243(d) and this section do not apply to dividends paid out of earnings and profits accumulated (i) by a corporation organized under the China Trade Act, 1922, (ii) by a domestic corporation during any period with respect to which such corporation was exempt from taxation under section 501 (relating to certain charitable, etc. organizations) or 521 (relating to farmers' cooperative associations), or (iii) by a domestic corporation during any period to which section 931 (relating to income from sources within possessions of the United States), as in effect for taxable years beginning before January 1, 1976, applied.

(b) *Establishing separate earnings and profits accounts.* A foreign corporation shall, for purposes of section 243(d), maintain a separate account for earnings and profits to which it succeeds which were accumulated by a domestic corporation, and such foreign corporation shall treat such earnings and profits as having been accumulated during the accounting periods in which earned by such domestic corporation. Such foreign corporation shall also maintain such a separate account for the earnings and profits, or deficit in earnings and profits, accumulated by it or accumulated by any other corporations to the earnings and profits of which it succeeds.

(c) *Effect of dividends on earnings and profits accounts.* Dividends paid out of the accumulated earnings and profits (see section 316(a)(1) of such foreign corporation shall be treated as having been paid out of the most recently accumulated earnings and profits of such corporation. A deficit in an earnings and profits account for any accounting period shall reduce the most recently accumulated earnings and profits for a prior accounting period in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior accounting period, such deficit must be restored before earnings and profits can be accumulated in a subsequent accounting period. If a dividend is paid out of earnings and profits of a foreign corporation which maintains two or more accounts (established under the provisions of paragraph (b) of this section) with respect to two or more accounting periods ending on the same day, then the portion of such dividend considered as paid out of each account shall be the same proportion of the total dividend as the amount of earnings and profits in that account bears to the sum of the earnings and profits in all such accounts.

(d) *Illustration.* The application of the principles of this section in the determination of the amount of the dividends received deduction may be illustrated by the following example:

Example. On December 31, 1960, corporation X, a calendar-year corporation organized in the United States on January 1, 1958, consolidated with corporation Y, a foreign corporation organized on January 1, 1958, which used an annual accounting period based on the calendar year, to form corporation Z, a foreign corporation not engaged in trade or business within the United States. Corporation Z is a wholly-owned subsidiary of corporation M, a domestic corporation. On January 1, 1961, corporation Z's accumulated earnings and profits of $31,000 are, under the provisions of paragraph (b) of this section, maintained in separate earnings and profits accounts containing the following amounts:

Earnings and profits accumulated for—	Domestic corp. X	Foreign corp. Y
1958	($1,000)	$11,000
1959	10,000	9,000
1960	5,000	(3,000)

Corporation Z had earnings and profits of $10,000 in each of the years 1961, 1962, and 1963 and makes distributions with respect to its stock to corporation M for such years in the following amounts:

1961	$14,000
1962	23,000
1963	16,000

(1) For 1961, a deduction of $3,400 is allowable to M with respect to the $14,000 distribution from Z, computed as follows:

(i) Dividend from current year earnings and profits (1961)	$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for 1960	4,000
(iii) Deduction: 85 percent of $4,000 (the amount distributed from the accumulated earnings and profits of corporation X)	3,400

(2) For 1962, a deduction of $6,970 is allowable to corporation M with respect to the $23,000 distribution from corporation Z, computed as follows:

(i) Dividend from current year earnings and profits (1962)		$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for:		
1960	$1,000	
1959: $9,000 (i.e., $10,000 − $1,000) divided by $15,000 (i.e., $9,000 + $9,000 − $3,000) multiplied by $12,000 (i.e., $23,000 − $11,000)	7,200	
Total	8,200	
(iii) Dividend from earnings and profits of corporation Y accumulated for:		
1959: $6,000/$15,000 × $12,000		4,800
(iv) Deduction: 85 percent of $8,200 (the amount distributed from the accumulated earnings and profits of corporation X)		6,970

(3) For 1963, a deduction of $1,530 is allowable to M with respect to the $16,000 distribution from Z, computed as follows:

(i) Dividend from current year earnings and profits (1963)	$10,000
(ii) Dividend from earnings and profits of corporation X accumulated for 1959:	
Earnings and profits remaining after 1962 distribution (i.e., $9,000 − $7,200)	1,800
(iii) Dividend from earnings and profits of corporation Y accumulated for 1959:	
Earnings and profits remaining after 1962 distribution (i.e., $6,000 − $4,800)	1,200
1958	8,000
(iv) Deduction: 85 percent of $1,800 (the amount distributed from the accumulated earnings and profits of corporation X)	1,530

[T.D. 6830, 30 FR 8045, June 23, 1965, as amended by T.D. 9194, 70 FR 18928, Apr. 11, 2005]

§ 1.243–4 Qualifying dividends.

(a) *Definition of qualifying dividends*—(1) *General*. For purposes of section 243(a)(3), the term *qualifying dividends* means dividends received by a corporation if:

(i) At the close of the day the dividends are received, such corporation is a member of the same affiliated group of corporations (as defined in paragraph (b) of this section) as the corporation distributing the dividends,

(ii) An election by such affiilated group under section 243(b)(2) and paragraph (c) of this section is effective for the taxable years of its members which include such day, and

(iii) The dividends are distributed out of earnings and profits specified in subparagraph (2) of this paragraph.

(2) *Earnings and profits*. The earnings and profits specified in this subparagraph are earnings and profits of a taxable year of the distributing corporation (or a predecessor corporation) which satisfies each of the following conditions:

(i) Such year must end after December 31, 1963;

(ii) On each day of such year the distributing corporation (or the predecessor corporation) and the corporation receiving the dividends must have been members of the affiliated group of which the distributing corporation and the corporation receiving the dividends are members on the day the dividends are received; and

(iii) An election under section 1562 (relating to the election of multiple surtax exmptions) was never effective (or is no longer effective pursuant to section 1562(c)) for such year.

(3) *Special rule for insurance companies*. Notwithstanding the provisions of subparagraph (2) of this paragraph, if an insurance company subject to taxation under section 802 or 821 distributes a dividend out of earnings and profits of a taxable year with respect to which the company would have been a component member of a controlled group of corporations within the meaning of section 1563 were it not for the application of section 1563(b)(2)(D), such dividend shall not be treated as a qualifying dividend unless an election under section 243(b)(2) is effective for such taxable year.

(4) *Predecessor corporations.* For purposes of this paragraph, a corporation shall be considered to be a predecessor corporation with respect to a distributing corporation if the distributing corporation succeeds to the earnings and profits of such corporation, for example, as the result of a transaction to which section 381(a) applies. A distributing corporation shall, for purposes of this section, maintain, in respect of each predecessor corporation, a separate account for earnings and profits to which it succeeds, and such earnings and profits shall be considered to be earnings and profits of the predecessor's taxable year in which the earnings and profits were accumulated.

(5) *Mere change in form.* (i) For purposes of subparagraph (2)(ii) of this paragraph, the affiliated group in existence during the taxable year out of the earnings and profits of which the dividend is distributed shall not be considered as a different group from that in existence on the day on which the dividend is received merely because:

(*a*) The common parent corporation has undergone a mere change in identity, form, or place of organization (within the meaning of section 368(a)(1)(F)), or

(*b*) A newly organized corporation (the ''acquiring corporation'') has acquired substantially all of the outstanding stock of the common parent corporation (the ''acquired corporation'') solely in exchange for stock of such acquiring corporation, and the stockholders (immediately before the acquisition) of the acquired corporation, as a result of owning stock of the acquired corporation, own (immediately after the acquisition) all of the outstanding stock of the acquiring corporation.

If a transaction described in the preceding sentence has occurred, the acquiring corporation shall be treated as having been a member of the affiliated group for the entire period during which the acquired corporation was a member of such group.

(ii) For purposes of subdivision (i) (b) of this subparagraph, if immediately before the acquisition:

(*a*) The stockholders of the acquired corporation also owned all of the outstanding stock of another corporation (the ''second corporation''), and

(*b*) Stock of the acquired corporation and of the second corporation could be acquired or transferred only as a unit (hereinafter referred to as the ''limitation on transferability''), then the second corporation shall be treated as an acquired corporation and such second corporation shall be treated as having been a member of the affiliated group for the entire period (while such group was in existence) during which the limitation on transferability was in existence, and if the second corporation is itself the common parent corporation of an affiliated group (the ''second group'') any other member of the second group shall be treated as having been a member of the affiliated group for the entire period during which it was a member of the second group while the limitation on transferability existed. For purposes of (*a*) of this subdivision and subdivision (i)(*b*) of this subparagraph, if the limitation on transferability of stock of the acquired corporation and the second corporation is achieved by using a voting trust, then the stock owned by the trust shall be considered as owned by the holders of the beneficial interests in the trust.

(6) *Source of distributions.* In determining from what year's earnings and profits a dividend is treated as having been distributed for purposes of this section, the principles of paragraph (a) of § 1.316–2 shall apply. A dividend shall be considered to be distributed, first, out of the earnings and profits of the taxable year which includes the date the dividend is distributed, second, out of the earnings and profits accumulated for the immediately preceding taxable year, third, out of the earnings and profits accumulated for the second preceding taxable year, etc. A deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior year, such deficit must be restored before earnings and profits can be accumulated in a subsequent year. If

a dividend is distributed out of separate earnings and profits accounts (established under the provisions of subparagraph (4) of this paragraph) for two or more taxable years ending on the same day, then the portion of such dividend considered as distributed out of each account shall be the same proportion of the total dividend as the amount of earnings and profits in that account bears to the sum of the earnings and profits in all such accounts.

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

Example 1. On March 1, 1965, corporation P, a publicly owned corporation, acquires all of the stock of corporation S and continues to hold the stock throughout the remainder of 1965 and all of 1966. P and S are domestic corporations which file separate returns on the basis of a calendar year. The affiliated group consisting of P and S makes an election under section 243(b)(2) which is effective for the 1966 taxable years of P and S. A multiple surtax exemption election under section 1562 is not effective for their 1965 taxable years. On February 1, 1966, S distributes $50,000 with respect to its stock which is received by P on the same date. S had earnings and profits of $40,000 for 1966 (computed without regard to distributions during 1966). S also had earnings and profits accumulated for 1965 of $70,000. Since $40,000 was distributed out of earnings and profits for 1966 and since each of the conditions prescribed in subparagraphs (1) and (2) of this paragraph is satisfied, P is entitled to a 100-percent dividends received deduction with respect to $40,000 of the $50,000 distribution. However, since $10,000 was distributed out of earnings and profits accumulated for 1965, and since on each day of 1965 S and P were not members of the affiliated group of which S and P were members on February 1, 1966, $10,000 of the $50,000 distribution does not satisfy the condition specified in subparagraph (2)(ii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction.

Example 2. Assume the same facts as in *Example 1,* except that corporation P acquires all the stock of corporation S on January 1, 1965, and sells such stock on November 1, 1966. Since $10,000 is distributed out of earnings and profits for 1965, and since each of the conditions prescribed in subparagraphs (1) and (2) of this paragraph is satisfied, P is entitled to a 100-percent dividends received deduction with respect to $10,000 of the $50,000 distribution. However, since $40,000 of the $50,000 distribution was made out of earnings and profits of S for its 1966 taxable year, and on each day of such year S and P were not members of the affiliated group of which S and P were members on February 1, 1966, $40,000 of the distribution does not satisfy the condition specified in subparagraph (2)(ii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction.

Example 3. Assume the same facts as in *Example 1,* except that corporation P acquires all the stock of corporation S on January 1, 1965, and that a multiple surtax exemption election under section 1562 is effective for P's and S's 1965 taxable years. Further assume that the section 1562 election is terminated effective with respect to their 1966 taxable years, and that an election under section 243(b) (2) is effective for such taxable years. Since $10,000 of the February 1, 1966, distribution was made out of earnings and profits of S for its 1965 taxable year and since a multiple surtax exemption election is effective for such year, $10,000 of the distribution does not satisfy the condition specified in subparagraph (2) (iii) of this paragraph and thus does not qualify for the 100-percent dividends received deduction. However, the portion of the distribution which was distributed out of earnings and profits of S's 1966 year ($40,000) qualifies for the 100-percent dividends received deduction.

Example 4. Assume the same facts as in *Example 1,* except that corporation P acquires all the stock of corporation S on January 1, 1965, and that S is a life insurance company subject to taxation under section 802. Accordingly, S would have been a member of a controlled group of corporations except for the application of section 1563(b)(2)(D). Since $10,000 of the distribution was made out of earnings and profits of S for its 1965 taxable year, and since with respect to such year an election under section 243(b)(2) was not effective, $10,000 of the distribution is not a qualifying dividend by reason of subparagraph (3) of this paragraph. On the other hand, the portion of the distribution which was distributed out of earnings and profits for S's 1966 year ($40,000) does qualify for the 100-percent dividends received deduction because the distribution was out of earnings and profits of a year for which an election under section 243(b) (2) is effective, and because the other conditions specified in subparagraphs (1) and (2) of this paragraph are satisfied. However, if P were also a life insurance company subject to taxation under section 802, then subparagraph (3) of this paragraph would not result in the disqualification of the portion of the distribution made out of S's 1965 earnings and profits because S would be a component member of an insurance group of corporations (as defined in section 1563(a)(4)), consisting of P and S, with respect to its 1965 year.

Example 5. Corporation X owns all the stock of corporation Y from January 1, 1965, through December 31, 1969. X and Y are domestic corporations which file separate returns on the basis of a calendar year. On June 30, 1965, Y acquired all the stock of domestic corporation Z, a calendar year taxpayer, and on December 31, 1967, Y acquired the assets of Z in a transaction to which section 381(a) applied. A multiple surtax exemption election under section 1562, was not effective for any taxable year of X, Y, or Z, and an election under section 243(b)(2) is effective for the 1968 and 1969 taxable years of X and Y. On January 1, 1968, Y's accumulated earnings and profits are, under the provisions of subparagraph (4) of this paragraph, maintained in separate earnings and profits accounts containing the following amounts:

Earnings and profits accumulated for	Corp Y	Corp Z
1964	$60,000	$40,000
1965	30,000	15,000
1966	(5,000)	2,000
1967	12,000	6,000

Corporation Y had earnings and profits of $10,000 in each of the years 1968 and 1969, and made distributions during such years in the following amounts:

1968	$29,000
1969	31,000

(i) The source of the 1968 distribution, determined in accordance with the rules of subparagraph (6) of this paragraph, is as follows:

(*a*) Dividend from Y's current year's earnings and profits (1968)	$10,000
(*b*) Dividend from earnings and profits of Y accumulated for 1967	12,000
(*c*) Dividend from earnings and profits of Z accumulated for:.	
1967	6,000
1966	1,000
	29,000

Since the 1968 dividend is considered paid out of earnings and profits of Y's 1968 and 1967 years, and Z's 1967 and 1966 years, and since each of these years satisfies each of the conditions specified in subparagraph (2) of this paragraph, X is entitled to a 100-percent dividends received deduction with respect to the entire 1968 distribution of $29,000 from Y.

(ii) The source of the 1969 distribution of $31,000, determined in accordance with the rules of subparagraph (6) of this paragraph, is as follows:

(*a*) Dividend from Y's current year's earnings and profits (1969)	$10,000
(*b*) Dividend from earnings and profits of Z accumulated for 1966 (1966 earnings and profits remaining after 1968 distribution, i.e., $2,000 − $1,000	1,000
(*c*) Dividend from earnings and profits of Y and Z accumulated for 1965:	
Corporation Y: $25,000 (i.e., $30,000 − $5,000 deficit) divided by $40,000 (i.e., the sum of the 1965 earnings and profits of Y and Z) multiplied by $20,000 (the portion of the distribution from the 1965 earnings and profits of Y and Z)	12,500
Corporation Z: $15,000 divided by $40,000 multiplied by $20,000	7,500
	31,000

The sum of the dividends from Y's 1969 year ($10,000), Z's 1966 year ($1,000), and Y's 1965 year ($12,500), or $23,500, qualifies for the 100-percent dividends received deduction. However, the dividends paid out of Z's 1965 year ($7,500) do not qualify because on each day of 1965 Z and X were not members of the affiliated group of which Y (the distributing corporation) and X (the corporation receiving the dividends) were members on the day in 1969 when the dividends were received by X.

(b) *Definition of affiliated group.* For purposes of this section and § 1.243–5, the term *affiliated group* shall have the meaning assigned to it by section 1504(a), except that insurance companies subject to taxation under section 802 or 821 shall be treated as includible corporations (notwithstanding section 1504(b)(2)), and the provisions of section 1504(c) shall not apply.

(c) *Election*—(1) *Manner and time of making election*—(i) *General.* The election provided by section 243(b)(2) shall be made for an affiliated group by the common parent corporation and shall be made for a particular taxable year of the common parent corporation. Such election may not be made for any taxable year of the common parent corporation for which a multiple surtax exemption election under section 1562 is effective. The election shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the common parent corporation, stating that the affiliated group elects under section 243(b)(2) for such taxable year. The statement shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the common parent. The statement shall set forth the name, address, taxpayer account number, and taxable year of each corporation (including wholly-owned subsidiaries) that is a member of the affiliated group at the time the election is filed. The statement may be filed at any time, provided that, with respect to each corporation the tax liability of which for its matching taxable year of election (or for any subsequent taxable year) would be increased because of the election, at the time of filing there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against such corporation for such year. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into an agreement to extend such statutory period for assessment and collection of deficiencies.

(ii) *Information statement by common parent*. If a corporation becomes a member of the affiliated group after the date on which the election is filed and during its matching taxable year of election, then the common parent shall file, within 60 days after such corporation becomes a member of the affiliated group, an additional statement containing the name, address, taxpayer account number, and taxable year of such corporation. Such additional statement shall be filed with the internal revenue officer with whom the election was filed.

(iii) *Definition of matching taxable year of election*. For purposes of this paragraph and paragraphs (d) and (e) of this section, the term *matching taxable year of election* shall mean the taxable year of each member (including the common parent corporation) of the electing affiliated group which includes the last day of the taxable year of the common parent corporation for which an election by the affiiliated group is made under section 243(b)(2).

(2) *Consents by subsidiary corporations*—(i) *General*. Each corporation (other than the common parent corporation) which is a member of the electing affiliated group (including any member which joins in the filing of a consolidated return) at any time during its matching taxable year of election must consent to such election in the manner and time provided in subdivision (ii) or (iii) of this subparagraph, whichever is applicable.

(ii) *Wholly owned subsidiary*. If all of the stock of a corporation is owned by a member or members of the affiliated group on each day of such corporation's matching taxable year of election, then such corporation (referred to in this paragraph as a ''wholly owned subsidiary'') shall be deemed to consent to such election.

(iii) *Other members*. The consent of each member of the affiliated group (other than a wholly owned subsidiary) shall be made by means of a statement, signed by any person who is duly authorized to act on behalf of the consenting member, stating that such member consents to the election under section 243(b)(2). The statement shall set forth the name, address, taxpayer account number, and taxable year of the consenting member and of the common parent corporation, and in the case of a statement filed after December 31, 1968, the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. The consent of more than one such member may be incorporated in a single statement. The statement (or statements) shall be attached to the election filed by the common parent corporation. The consent of a corporation that, after the date the election was filed and during its matching taxable year of election, either (*a*) becomes a member, or (*b*) ceases to be a wholly owned subsidiary but continues to be a member, shall be filed with the internal revenue officer with whom the election was filed and shall be filed on or before the date prescribed by law (including extensions of time) for the filing of the consenting member's income tax return for such taxable year, or on or before June 10, 1964, whichever is later.

(iv) *Statement attached to return*. Each corporation that consents to an election by means of a statement described in subdivision (iii) of this subparagraph should attach a copy of the statement to its income tax return for its matching taxable year of election, or, if such return has already been filed, to its first income tax return filed on or after the date on which the statement is filed. However, if such return is filed on or before June 10, 1964, a copy of such statement should be filed on or before June 10, 1964, with the district director with whom such return is filed. Each wholly owned subsidiary should attach a statement to its income tax return for its matching taxable year of election, or, if such return has already been filed, to its first income tax return filed on or after the date on which the statement is filed stating that it is subject to an election under section 243(b)(2) and the taxable year to which the election applies, and setting forth the name, address, taxpayer account number, and taxable year of the common parent corporation, and in the case of a statement filed after December 31, 1968, the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. However, if the due date for such return (including extensions of time) is before June 10, 1964, such statement should be filed on or before June 10, 1964, with the district director with whom such return is filed.

(3) *Information statement by member.* If a corporation becomes a member of the affiliated group during a taxable year that begins after the last day of the common parent corporation's matching taxable year of election, then (unless such election has been terminated) such corporation should attach a statement to its income tax return for such taxable year stating that it is subject to an election under section 243(b)(2) for such taxable year and setting forth the name, address, taxpayer account number, and taxable year of the common parent corporation, and the identity of the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation. In the case of an affiliated group that made an election under the rules provided in Treasury Decision 6721, approved April 8, 1964 (29 FR 4997, C.B. 1964–1 (Part 1), 625), such statement shall be filed, on or before March 15, 1969, with the district director for the internal revenue district in which is located such member's principal place of business or principal office or agency.

(4) *Years for which election effective*—(i) *General rule.* An election under section 243(b)(2) by an affiliated group shall be effective:

(*a*) In the case of each corporation which is a member of such group at any time during its matching taxable year of election, for such taxable year, and

(*b*) In the case of each corporation which is a member of such group at any time during a taxable year ending after the last day of the common parent's taxable year of election but which does not include such last day, for such taxable year, unless the election is terminated under section 243(b)(4) and paragraph (e) of this section. Thus, the election has a continuing effect and need not be renewed annually.

(ii) *Special rule for certain taxable years ending in 1964.* In the case of a taxable year of a member (other than the common parent corporation) of the affiliated group (*a*) which begins in 1963 and ends in 1964, and (*b*) for which an election is not effective under subdivision (i)(*a*) of this subparagraph, if an election under section 243(b)(2) is effective for the taxable year of the common parent corporation which includes the last day of such taxable year of such member, then such election shall be effective for such taxable year of such member if such member files a separate consent with respect to such taxable year. However, in order for a dividend distributed by such member during such taxable year to meet the requirements of section 243(b)(1), an election under section 243(b)(2) must be effective for the taxable year of each member of the affiliated group which includes the date such dividend is received. See section 243(b)(1)(A) and paragraph (a)(1) of this section. Accordingly, if the dividend is to qualify for the 100-percent dividends received deduction under section 243(a)(3), a consent must be filed under this subdivision by each member of the affiliated group with respect to its taxable year which includes the day the dividend is received (unless an election is effective for such taxable year under subdivision (i)(*a*) of this subparagraph). For purposes of this subdivision, a consent shall be made by means of a statement meeting the requirements of subparagraph (2)(iii) of this paragraph, and shall be attached to the election made by the common parent corporation for its taxable year which includes the last day of the taxable year of the member with respect to which the consent is made. A copy of the statement should be filed, within 60 days after such election is filed by the common parent corporation, with the district director with whom the consenting member filed its income tax return for such taxable year.

(iii) *Examples.* The provisions of subdivision (ii) of this subparagraph, relating to the special rule for certain taxable years ending in 1964, may be illustrated by the following examples:

Example 1. P Corporation owns all the stock of S–1 Corporation on each day of 1963, 1964, and 1965. P uses the calendar year as its taxable year and S–1 uses a fiscal year ending June 30 as its taxable year. P makes an election under section 243(b)(2) for 1964. Since S–1 is a wholly owned subsidiary for its taxable year ending June 30, 1965, it is deemed to consent to the election. However, in order for the election to be effective with respect to S–1's taxable year ending June 30, 1964, a statement specifying that S–1 consents to the election with respect to such taxable year and containing the information required in a statement of consent under subparagraph (2)(iii) of this paragraph must be attached to the election.

Example 2. Assume the same facts as in *Example 1,* except that P also owns all the stock of S–2 Corporation on each day of 1963, 1964, and 1965. S–2 uses a fiscal year ending May 31 as its taxable year. If S–1 distributes a dividend to P on January 15, 1964, the dividend may qualify under section 243(a)(3) only if S–1 and S–2 both consent to the election made by P for 1964 with respect to their taxable years ending in 1964.

Example 3. Assume the same facts as in *Example 1,* except that P uses a fiscal year ending on January 31 as its taxable year and makes an election under subparagraph (1) of this paragraph for its taxable year ending January 31, 1964. Since S–1's taxable year beginning in 1963 and ending in 1964 includes January 31, 1964, the last day of P's taxable year for which the election was made, the election is effective under subdivision (i)(*a*) of this subparagraph, for S–1's taxable year ending June 30, 1964. Accordingly, the special rule of subdivision (ii) of this subparagraph has no application.

(d) *Effect of election.* For restrictions and limitations applicable to corporations which are members of an electing affiliated group on each day of their taxable years, see §1.243–5.

(e) *Termination of election*—(1) *In general.* An election under section 243(b)(2) by an affiliated group may be terminated with respect to any taxable year of the common parent corporation after the matching taxable year of election of the common parent corporation. The election is terminated as a result of one of the occurrences described in subparagraph (2) or (3) of this paragraph. For years affected by termination, see subparagraph (4) of this paragraph.

(2) *Consent of members*—(i) *General.* An election may be terminated for an affiliated group by its common parent corporation with respect to a taxable year of the common parent corporation provided each corporation (other than the common parent) that was a member of the affiliated group at any time during its taxable year that includes the last day of such year of the common parent (the ''matching taxable year of termination'') consents to such termination. The statement of termination may be filed by the common parent corporation at any time, provided that, with respect to each corporation the tax liability of which for its matching taxable year of termination (or for any subsequent taxable year) would be increased because of the termination, at the time of filing there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against such corporation for such year. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into agreement to extend such statutory period for assessment and collection of deficiencies.)

(ii) *Statements filed after December 31, 1968.* With respect to statements of termination filed after December 31, 1968:

(*a*) The statement shall be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the common parent corporation;

(*b*) The statement shall be signed by any person who is duly authorized to act on behalf of the common parent corporation and shall state that the affiliated group terminates the election under section 243(b)(2) for such taxable year;

(*c*) The statement shall set forth the name, address, taxpayer account number, and taxable year of each corporation (including wholly owned subsidiaries) which is a member of the affiliated group at the time the termination is filed; and

(*d*) The consents to the termination shall be given in accordance with the rules prescribed in paragraph (c)(2) of this section, relating to manner and time for giving consents to an election under section 243(b)(2).

(3) *Refusal by new member to consent*—(i) *Manner of giving refusal.* If any corporation which is a new member of an affiliated group with respect to a taxable year of the common parent corporation (other than the matching taxable year of election of the common parent corporation) files a statement that it does not consent to an election under section 243(b)(2) with respect to such taxable year, then such election shall terminate with respect to such taxable year. Such statement shall be signed by any person who is duly authorized to act on behalf of the new member, and shall be filed with the timely filed income tax return of such new member for its taxable year within which falls the last day of such taxable year of the common parent corporation. In the event of a termination under this subparagraph, each corporation (other than such new member) that is a member of the affiliated group at any time during its taxable year which includes such last day should, within 30 days after such new member files the statement of refusal to consent, notify the district director of such termination. Such notification should be filed with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation.

(ii) *Corporation considered as new member.* For purposes of subdivision (i) of this subparagraph, a corporation shall be considered to be a new member of an affiliated group of corporations with respect to a taxable year of the common parent corporation if such corporation:

(*a*) Is a member of the affiliated group at any time during such taxable year of the common parent corporation, and

(*b*) Was not a member of the affiliated group at any time during the common parent corporation's immediately preceding taxable year.

(4) *Effect of termination.* A termination under subparagraph (2) or (3) of this paragraph is effective with respect to (i) the common parent corporation's taxable year referred to in the particular subparagraph under which the termination occurs, and (ii) the taxable years of the other members of the affiliated group which include the last day of such taxable year of the common parent. An election, once terminated, is no longer effective. Accordingly, the termination is also effective with respect to the succeeding taxable years of the members of the group. However, the affiliated group may make a new election in accordance with the provisions of section 243(b)(2) and paragraph (c) of this section.

[T.D. 6992, 34 FR 817, Jan. 18, 1969]

§ 1.243–5 Effect of election.

(a) *General*—(1) *Corporations subject to restrictions and limitations.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then each corporation (including the common parent corporation) which is a member of such group on each day of its matching taxable year shall be subject to the restrictions and limitations prescribed by paragraphs (b), (c), and (d) of this section for such taxable year. For purposes of this section, the term *matching taxable year* shall mean the taxable year of each member (including the common parent corporation) of an affiliated group which includes the last day of a particular taxable year of the common parent corporation for which an election by the affiliated group under section 243(b)(2) is effective. If a corporation is a member of an affiliated group on each day of a short taxable year which does not include the last day of a taxable year of the common parent corporation, and if an election under section 243(b)(2) is effective for such short year, see paragraph (g) of this section. In the case of taxable years beginning in 1963 and ending in 1964 for which an election under section 243(b)(2) is effective under paragraph (c)(4)(ii) of §1.243–4, see paragraph (f)(9) of this section.

(2) *Members filing consolidated returns.* The restrictions and limitations prescribed by this section shall apply notwithstanding the fact that some of the corporations which are members of the electing affiliated group (within the meaning of section 243(b)(5)) join in the filing of a consolidated return. Thus, for example, if an electing affiliated group includes one or more corporations taxable under section 11 of the Code and two or more insurance companies taxable under section 802 of the Code, and if the insurance companies join in the filing of a consolidated return, the amount of such companies' exemptions from estimated tax (for purposes of sections 6016 and 6655) shall be the amounts determined under paragraph (d)(5) of this section and not the amounts determined pursuant to the regulations under section 1502.

(b) *Multiple surtax exemption election*—(1) *General rule.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then no corporation which is a member of such affiliated group on each day of its matching taxable year may consent (or shall be deemed to consent) to an election under section 1562(a)(1), relating to election of multiple surtax exemptions, which would be effective for such matching taxable year. Thus, each corporation which is a component member of the controlled group of corporations with respect to its matching taxable year (determined by applying section 1563(b) without regard to paragraph (2)(D) thereof) shall determine its surtax exemption for such taxable year in accordance with section 1561 and the regulations thereunder.

(2) *Special rule for certain insurance companies.* Under section 243(b)(6)(A), if the provisions of subparagraph (1) of this paragraph apply with respect to the taxable year of an insurance company subject to taxation under section 802 or 821, then the surtax exemption of such insurance company for such taxable year shall be determined by applying part II (section 1561 and following), subchapter B, chapter 6 of the Code, with respect to such insurance company and the other corporations which are component members of the controlled group of corporations (as determined under section 1563 without regard to subsections (a)(4) and (b)(2)(D) thereof) of which such insurance company is a member, without regard to section 1563(a)(4) (relating to certain insurance companies treated as a separate controlled group) and section 1563(b)(2)(D) (relating to certain insurance companies treated as excluded members).

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

Example. Throughout 1965 corporation M owns all the stock of corporations L–1, L–2, S–1, and S–2. M is a domestic mutual insurance company subject to tax under section 821 of the Code, L–1 and L–2 are domestic life insurance companies subject to tax under section 802 of the Code, and S–1 and S–2 are domestic corporations subject to tax under section 11 of the Code. Each corporation uses the calendar year as its taxable year. M makes a valid election under section 243(b)(2) for the affiliated group consisting of M, L–1, L–2, S–1, and S–2. If part II, subchapter B, chapter 6 of the Code were applied with respect to the 1965 taxable years of the corporations without regard to section 243(b)(6)(A), the following would result: S–1 and S–2 would be treated as component members of a controlled group of corporations on such date; L–1 and L–2 would be treated as component members of a separate controlled group on such date; and M would be treated as an excluded member. However, since section 243(b)(6)(A) requires that part II of subchapter B be applied without regard to section 1563(a)(4) and (b)(2)(D), for purposes of determining the surtax exemptions of M, L–1, L–2, S–1, and S–2 for their 1965 taxable years, such corporations are treated for purposes of such part II as component members of a single controlled group of corporations on December 31, 1965. Moreover, by reason of having made the election under section 243(b)(2), M, L-1, L–2, S–1, and S–2 cannot consent to multiple surtax exemption elections under section 1562 which would be effective for their 1965 taxable years. Thus, such corporations are limited to a single $25,000 surtax exemption for such taxable years (to be apportioned among such corporations in accordance with section 1561 and the regulations thereunder).

(c) *Foreign tax credit*—(1) *General.* If an election by an affiliated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then:

(i) The credit under section 901 for taxes paid or accrued to any foreign country or possession of the United States shall be allowed to a corporation which is a member of such affiliated group for each day of its matching taxable year only if each other corporation which pays or accrues such foreign taxes to any foreign country or possession, and which is a member of such group on each day of its matching taxable year, does not deduct such taxes in computing its tax liability for its matching taxable year, and

(ii) A corporation which is a member of such affiliated group on each day of its matching taxable year may use the overall limitation provided in section 904(a)(2) for such matching taxable year only if each other corporation which pays or accrues foreign taxes to any foreign country or possession, and which is a member of such group on each day of its matching taxable year, uses such limitation for its matching taxable year.

(2) *Consent of the Commissioner.* In the absence of unusual circumstances, a request by a corporation for the consent of the Commissioner to the revocation of an election of the overall limitation, or to a new election of the overall limitation, for the purpose of satisfying the requirements of subparagraph (1)(ii) of this paragraph will be given favorable consideration, notwithstanding the fact that there has been no change in the basic nature of the corporation's business or changes in conditions in a foreign country which substantially affect the corporation's business. See paragraph (d)(3) of §1.904–1.

(d) *Other restrictions and limitations*—(1) *General rule.* If an election by an affilated group under section 243(b)(2) is effective with respect to a taxable year of the common parent corporation, then, except to the extent that an apportionment plan adopted under paragraph (f) of this section for such taxable year provides otherwise with respect to a restriction or limitation described in this paragraph, the rules provided in subparagraphs (2), (3), (4), and (5) of this paragraph shall apply to each corporation which is a member of such affiliated group on each day of its matching taxable year for the purpose of computing the amount of such restriction or limitation for its matching taxable year. For purposes of this paragraph, each corporation which is a member of an electing affiliated group (including any member which joins in filing a consolidated return) shall be treated as a separate corporation for purposes of determining the amount of such restrictions and limitations.

(2) *Accumulated earnings credit*—(i) *General.* Except as provided in subdivision (ii) of this subparagraph, in determining the minimum accumulated earnings credit under section 535(c)(2) (or the accumulated earnings credit of a mere holding or investment company under section 535(c)(3) for each corporation which is a member of the affiliated group on each day of its matching taxable year, in lieu of the $150,000 amount ($100,000 amount in the case of taxable years beginning before January 1, 1975) mentioned in such sections there shall be substituted an amount equal to (*a*) $150,000 ($100,000 in the case of taxable years beginning before January 1, 1975), divided by (*b*) the number of such members.

(ii) *Allocation of excess.* If, with respect to one or more members, the amount determined under subdivision (i) of this subparagraph exceeds the sum of (*a*) such member's accumulated earnings and profits as of the close of the preceding taxable year, plus (*b*) such member's earnings and profits for the taxable year which are retained (within the meaning of section 535(c)(1), then any such excess shall be subtracted from the amount determined under subdivision (i) of this subparagraph and shall be divided equally among those remaining members of the affiliated group that do not have such an excess (until no such excess remains to be divided among those remaining members that have not had such an excess). The excess so divided among such remaining members shall be added to the amount determined under subdivision (i) with respect to such members.

(iii) *Apportionment plan not allowed.* An affiliated group may not adopt an apportionment plan, as provided in paragraph (f) of this section, with respect to the amounts computed under the provisions of this subparagraph.

(iv) *Example.* The provisions of this subparagraph may be illustrated by the following example;

Example. An affiliated group is composed of four member corporations, W, X, Y, and Z. The sum of the accumulated earnings and profits (as of the close of the preceding taxable year ending December 31, 1975) plus the earnings and profits for the taxable year ending December 31, 1976 which are retained is $15,000, $75,000, $37,500, and $300,000 in the case of W, X, Y, and Z, respectively. The amounts determined under this subparagraph for W, X, Y, and Z are $15,000, $48,750, $37,500 and $48,750, respectively, computed as follows:

	Component members			
	W	X	Y	Z
Earnings and profits	$15,000	$75,000	$37,500	$300,000
Amount computed under subpar. (1)	37,500	37,500	37,500	37,500
Excess	22,500	0	0	0
Allocation of excess	....	7,500	7,500	7,500
New excess	....	....	7,500	
Reallocation of new excess	....	3,750	....	3,750
Amount to be used for purposes of sec. 535(c) (2) and (3)	15,000	48,750	37,500	48,750

(3) *Mine exploration expenditures*—(i) *Limitation under section 615(a).* If the aggregate of the expenditures to which section 615(a) applies, which are paid or incurred by corporations which are members of the affiliated group on each day of their matching taxable years (during such taxable years) exceeds $100,000, then the deduction (or amount deferrable) under section 615 for any such member for its matching taxable year shall be limited to an amount equal to the amount which bears the same ratio to $100,000 as the amount deductible or deferrable by such member under section 615 (computed without regard to this subdivision) bears to the aggregate of the amounts deductible or deferrable under section 615 (as so computed) by all such members.

(ii) *Limitation under section 615(c).* If the aggregate of the expenditures to which section 615(a) applies which are paid or incurred by the corporations which are members of such affiliated group on each day of their matching taxable years (during such taxable years) would, when added to the aggregate of the amounts deducted or deferred in prior taxable years which are taken into account by such corporations in applying the limitation of section 615(c), exceed $400,000, then section 615 shall not apply to any such expenditure so paid or incurred by any such member to the extent such expenditure would exceed the amount which bears the same ratio to (*a*) the amount, if any, by which $400,000 exceeds the amounts so deducted or deferred in prior years, as (*b*) such member's deduction (or amount deferrable) under section 615 (computed without regard to this subdivision) for such expenditures paid or incurred by such member during its matching taxable year, bears to (*c*) the aggregate of the amounts deductible or deferrable under section 615 (as so computed) by all such members during their matching taxable years.

(iii) *Treatment of corporations filing consolidated returns.* For purposes of making the computations under subdivisions (i) and (ii) of this subparagraph, a corporation which joins in the filing of a consolidated return shall be treated as if it filed a separate return.

(iv) *Estimate of exploration expenditures.* If, on the date a corporation (which is a member of an affiliated group on each day of its matching taxable year) files its income tax return for such taxable year, it cannot be determined whether or not the $100,000 limitation prescribed by subdivision (i) of this subparagraph, or the $400,000 limitation prescribed by subdivision (ii) of this subparagraph, will apply with respect to such taxable year, then such member shall, for purposes of such return, apply the provisions of such subdivisions (i) and (ii) with respect to such taxable year on the basis of an estimate of the aggregate of the exploration expenditures by all such members of the affiliated group for their matching taxable years. Such estimate shall be made on the basis of the facts and circumstances known at the time of such estimate. If an estimate is used by any such member of the affiliated group pursuant to this subdivision, and if the actual expenditures by all such members differ from the estimate, then each such member shall file as soon as possible an original or amended return reflecting an amended apportionment (either pursuant to an apportionment plan adopted under paragraph (f) of this section or pursuant to the application of the rule provided by subdivision (i) or (ii) of this subparagraph) based upon such actual expenditures.

(v) *Amount apportioned under apportionment plan.* If an electing affiliated group adopts an apportionment plan as provided in paragraph (f) of this section with respect to the limitation under section 615(a) or 615(c), then the amount apportioned under such plan to any corporation which is a member of such group may not exceed the amount which such member could have deducted (or deferred) under section 615 had such affiliated group not filed an election under section 243(b)(2).

(4) *Small business deductions of life insurance companies.* In the case of a life insurance company taxable under section 802 which is a member of such affiliated group on each day of its matching taxable year, the small business deduction under sections 804(a)(4) and 809(d)(10) shall not exceed an amount equal to $25,000 divided by the number of life insurance companies taxable under section 802 which are members of such group on each day of their matching taxable years.

(5) *Estimated tax*—(i) *Exemption from estimated tax.* Except as otherwise provided in subdivision (ii) of this subparagraph, the exemption from estimated tax (for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax) of each corporation which is a member of such affiliated group on each day of its matching taxable year shall be (in lieu of the $100,000 amount specified in section 6016(a) and (b)(2)(A) and in section 6655(d)(1) and (e)(2)(A) an amount equal to $100,000 divided by the number of such members.

(ii) *Nonapplication to certain taxable years beginning in 1963 and ending in 1964.* For purposes of this section, if a corporation has a taxable year beginning in 1963 and ending in 1964 the last day of the eighth month of which falls on or before April 10, 1964, then (notwithstanding the fact that an election under section 243(b)(2) is effective for such taxable year) subdivision (i) of this subparagraph shall not apply to such corporation for such taxable year. Thus, such corporation shall be entitled to a $100,000 exemption from estimated tax for such taxable year. Also, with respect to a taxable year described in the first sentence of this subdivision, any such corporation shall not be considered to be a member of the affiliated group for purposes of determining the number of members referred to in subdivision (i) of this subparagraph.

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

Example 1. Corporation P owns all the stock of corporation S–1 on each day of 1965. On March 1, 1965, P acquires all the stock of corporation S–2. Corporations P, S–1, and S–2 file separate returns on a calendar year basis. On March 31, 1965, the affiliated group consisting of P, S–1, and S–2 anticipates making an election under section 243(b)(2) for P's 1965 taxable year. If the affiliated group does make a valid election under section 243(b)(2) for P's 1965 year, under subdivision (i) of this subparagraph the exemption from estimated tax of P for 1965, and the exemption from estimated tax of S–1 for 1965, will be (assuming an apportionment plan is not filed pursuant to paragraph (f) of this section) an amount equal to $50,000 ($100,000 ÷ 2). (Since S–2 is not a member of the affiliated group on each day of 1965, S–2's exemption from estimated tax will be determined for the year 1965 without regard to subdivision (i) of this subparagraph, whether or not the affiliated group makes the election under section 243(b)(2).) P and S–1 file declarations of estimated tax on April 15, 1965, on such basis and make payments with respect to such declarations on such basis.

Thus, if the affiliated group does make a valid election under section 243(b)(2) for P's 1965 year, P and S–1 will not incur (as a result of the application of subdivision (i) of this subparagraph to their 1965 years) additions to tax under section 6655 for failure to pay estimated tax.

Example 2. Assume the same facts as in *Example 1,* except that, on March 31, 1965, S–1 anticipates that it will incur a loss for its 1965 year. Accordingly, in anticipation of making an election under section 243(b)(2) for P's 1965 year and adopting an apportionment plan under paragraph (f) of this section, P computes its estimated tax liability for 1965 on the basis of a $100,000 exemption, and S–1 computes its estimated tax liability for 1965 on the basis of a zero exemption. Assume S–1 incurs a loss for 1965 as anticipated. Thus, if P does make the election for 1965, and an apportionment plan is adopted apportioning $100,000 to P and zero to S–1 (for their 1965 years), P and S–1 will not incur (as a result of the application of subdivision (i) of this subparagraph to their 1965 years) additions to tax under section 6655 for failure to pay estimated tax.

Example 3. Assume the same facts as in *Example 1,* except that P and S–1 file declarations of estimated tax on April 15, 1965, on the basis of separate $100,000 exemptions from estimated tax for their 1965 years, and make payments with respect to such declarations on such basis. Assume that the affiliated group makes an election under section 243(b)(2) for P's 1965 year. Under subdivision (i) of this subparagraph, P and S–1 are limited in the aggregate to a single $100,000 exemption from estimated tax for their 1965 years. The provisions of section 6655 will be applied to the 1965 year of P and the 1965 year of S–1 on the basis of a $50,000 exemption from estimated tax for each corporation, unless a different apportionment of the $100,000 amount is adopted under paragraph (f) of this section. Since the election was made under section 243(b)(2), regardless of whether or not the affiliated group anticipated making the election, P or S–1 (or both) may incur additions to tax under section 6655 for failure to pay estimated tax.

(e) *Effect of election for certain taxable years beginning in 1963 and ending in 1964.* If an election under section 243(b)(2) by an affiliated group is effective for a taxable year of a corporation under paragraph (c)(4)(ii) of §1.243–4 (relating to election for certain taxable years beginning in 1963 and ending in 1964), and if such corporation is a member of such group on each day of such taxable year, then the restrictions and limitations prescribed by paragraphs (b), (c), and (d) of this section shall apply to all such members having such taxable years (for such taxable years). For purposes of this paragraph, such paragraphs shall be applied with respect to such taxable years as if such taxable years included the last day of a taxable year of the common parent corporation for which an election was effective under section 243(b)(2), *i.e.,* as if such taxable years were matching taxable years. For apportionment plans with respect to such taxable years, see paragraph (f) (9) of this section.

(f) *Apportionment plans*—(1) *In general.* In the case of corporations which are members of an affiliated group of corporations on each day of their matching taxable years:

(i) The $100,000 amount referred to in paragraph (d)(3)(i) of this section (relating to limitation under section 615(a)),

(ii) The amount determined under paragraph (d)(3)(ii)(*a*) of this section (relating to limitation under section 615(c)),

(iii) The $25,000 amount referred to in paragraph (d)(4) of this section (relating to small business deduction of life insurance companies), and

(iv) The $100,000 amount referred to in paragraph (d)(5)(i) of this section (relating to exemption from estimated tax), may be apportioned among such members (for such taxable years) if the common parent corporation files an apportionment plan with respect to such taxable years in the manner provided in subparagraph (4) of this paragraph, and if all other members consent to the plan, in the manner provided in subparagraph (5) or (6) of this paragraph (whichever is applicable). The plan may provide for the apportionment to one or more of such members, in fixed dollar amounts, of one or more of the amounts referred to in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, but in no event shall the sum of the amounts so apportioned in respect to any such subdivision exceed the amount referred to in such subdivision. See also paragraph (d)(3)(v) of this section, relating to the maximum amount that may be apportioned to a corporation under this subparagraph with respect to exploration expenditures to which section 615 applies.

(2) *Time for adopting plan.* An affiliated group may adopt an apportionment plan with respect to the matching taxable years of its members only if, at the time such plan is sought to be adopted, there is at least 1 year remaining in the statutory period (including any extensions thereof) for the assessment of a deficiency against any corporation the tax liability of which for any taxable year would be increased by the adoption of such plan. (If there is less than 1 year remaining with respect to any taxable year, the district director for the internal revenue district in which is located the principal place of business or principal office or agency of the corporation will ordinarily, upon request, enter into an agreement to extend such statutory period for assessment and collection of deficiencies.)

(3) *Years for which effective.* A valid apportionment plan with respect to matching taxable years of members of an affiliated group shall be effective for such matching taxable years, and for all succeeding matching taxable years of such members, unless the plan is amended in accordance with subparagraph (8) of this paragraph or is terminated. Thus, the apportionment plan (including any amendments thereof) has a continuing effect and need not be renewed annually. An apportionment plan with respect to a particular taxable year of the common parent shall terminate with respect to the taxable years of the members of the affiliated group which include the last day of a succeeding taxable year of the common parent if:

(i) Any corporation which was a member of the affiliated group on each day of its matching taxable year which included the last day of the particular taxable year of the common parent is not a member of such group on each day of its taxable year which includes the last day of such succeeding taxable year of the common parent, or

(ii) Any corporation which was not a member of such group on each day of its taxable year which included the last day of the particular taxable year of the common parent is a member of such group on each day of its taxable year which includes the last day of such succeeding taxable year of the common parent.

An apportionment plan, once terminated, is no longer effective. Accordingly, unless a new apportionment plan is filed and consented to (or the section 243(b)(2) election is terminated) the amounts referred to in subparagraph (1) of this paragraph will be apportioned among the corporations which are members of the affiliated group on each day of their matching taxable years in accordance with the rules provided in paragraphs (d)(3)(i), (d)(3)(ii), (d)(4), and (d)(5)(i) of this section.

(4) *Filing of plan.* The apportionment plan shall be in the form of a statement filed by the common parent corporation with the district director for the internal revenue district in which is located the principal place of business or principal office or agency of such common parent. The statement shall be signed by any person who is duly authorized to act on behalf of the common parent corporation and shall set forth the name, address, internal revenue district, taxpayer account number, and taxable year of each member to whom the common parent could apportion an amount under subparagraph (1) of this paragraph (or, in the case of an apportionment plan referred to in subparagraph (9) of this paragraph, each member to whom the common parent could apportion an amount under such subparagraph) and the amount (or amounts) apportioned to each such member under the plan.

(5) *Consent of wholly owned subsidiaries.* If all the stock of a corporation which is a member of the affiliated group on each day of its matching taxable year is owned on each such day by another corporation (or corporations) which is a member of such group on each day of its matching taxable year, such corporation (hereinafter in this paragraph referred to as a ''wholly owned subsidiary'') shall be deemed to consent to the apportionment plan. Each wholly owned subsidiary should attach a copy of the plan filed by the common parent corporation to an income tax return, amended return, or claim for refund for its matching taxable year.

(6) *Consent of other members.* The consent of each member (other than the

common parent corporation and wholly owned subsidiaries) to an apportionment plan shall be in the form of a statement, signed by any person who is duly authorized to act on behalf of the member consenting to the plan, stating that such member consents to the plan. The consent of more than one such member may be incorporated in a single statement. The statement (or statements) shall be attached to the apportionment plan filed by the common parent corporation. The consent of any such member which, after the date the apportionment plan was filed and during its matching taxable year referred to in subparagraph (1) of this paragraph, ceases to be a wholly owned subsidiary but continues to be a member, shall be filled with the district director with whom the apportionment plan is filed (as soon as possible after it ceases to be a wholly owned subsidiary). Each consenting member should attach a copy of the apportionment plan filed by the common parent to an income tax return, amended return, or claim for refund for its matching taxable year which includes the last day of the taxable year of the common parent corporation for which the apportionment plan was filed.

(7) *Members of group filing consolidated return*—(i) *General rule.* Except as provided in subdivision (ii) of this subparagraph, if the members of an affiliated group of corporations include one or more corporations taxable under section 11 of the Code and one or more insurance companies taxable under section 802 or 821 of the Code and if the affiliated group includes corporations which join in the filing of a consolidated return, then, for purposes of determining the amount to be apportioned to a corporation under an apportionment plan adopted under this paragraph, the corporations filing the consolidated return shall be treated as a single member.

(ii) *Consenting to an apportionment plan.* For purposes of consenting to an apportionment plan under subparagraphs (5) and (6) of this paragraph, if the members of an affiliated group of corporations include corporations which join in the filing of a consolidated return, each corporation which joins in filing the consolidated return shall be treated as a separate member.

(8) *Amendment of plan.* An apportionment plan, which is effective for the matching taxable years of members of an affiliated group, may be amended if an amended plan is filed (and consented to) within the time and in accordance with the rules prescribed in this paragraph for the adoption of an original plan with respect to such taxable years.

(9) *Certain taxable years beginning in 1963 and ending in 1964.* In the case of corporations which are members of an affiliated group of corporations on each day of their taxable years referred to in paragraph (e) of this section:

(i) The $100,000 amount referred to in paragraph (d)(3)(i) of this section (relating to limitation under section 615(a)),

(ii) The amount determined under paragraph (d)(3)(ii)(*a*) of this section (relating to limitation under section 615(c)),

(iii) The $25,000 amount referred to in paragraph (d)(4) of this section (relating to small business deduction of life insurance companies), and

(iv) The $100,000 amount referred to in paragraph (d)(5)(i) of this section (relating to exemption from estimated tax), may be apportioned among such members (for such taxable years) if an apportionment plan is filed (and consented to) with respect to such taxable years in accordance with the rules provided in subparagraphs (2), (4), (5), (6), (7), and (8) of this paragraph. For purposes of this subparagraph, such subparagraphs shall be applied as if such taxable years included the last day of a taxable year of the common parent corporation, i.e., as if such taxable years were matching taxable years. An apportionment plan adopted under this subparagraph shall be effective only with respect to taxable years referred to in paragraph (e) of this section. The plan may provide for the apportionment to one or more of such members, in fixed dollar amounts, of one or more of the amounts referred to in subdivisions (i), (ii), (iii), and (iv) of this subparagraph, but in no event shall the sum of the amounts so apportioned in respect of any such subdivision exceed the amount referred to in such subdivision. See also paragraph (d)(3)(v) of this section, relating to the maximum amount that may be apportioned to a corporation under an apportionment plan described in this subparagraph with respect to exploration expenditures to which section 615 applies.

(g) *Short taxable years*—(1) *General.* If:

(i) The return of a corporation is for a short period (ending after December 31, 1963) on each day of which such corporation is a member of an affiliated group,

(ii) The last day of the common parent's taxable year does not end with or within such short period, and

(iii) An election under section 243(b)(2) by such group is effective under paragraph (c) (4) (i) of §1.243–4 for the taxable year of the common parent within which falls such short period, then the restrictions and limitations prescribed by section 243(b)(3) shall be applied in the manner provided in subparagraph (2) of this paragraph.

(2) *Manner of applying restrictions.* In the case of a corporation described in subparagraph (1) of this paragraph having a short period described in such subparagraph:

(i) Such corporation may not consent to an election under section 1562, relating to election of multiple surtax exemptions, which would be effective for such short period;

(ii) The credit under section 901 shall be allowed to such corporation for such short period if, and only if, each corporation, which pays or accrues foreign taxes and which is a member of the affiliated group on each day of its taxable year which includes the last day of the common parent's taxable year within which falls such short period, does not deduct such taxes in computing its tax liability for its taxable year which includes such last day;

(iii) The overall limitation provided in section 904(a)(2) shall be allowed to such corporation for such short period if, and only if, each corporation, which pays or accrues foreign taxes and which is a member of the affiliated group on each day of its taxable year which includes the last day of the common parent's taxable year within which falls such short period, uses such limitation for its taxable year which includes such last day;

(iv) The minimum accumulated earnings credit provided by section 535(c)(2) (or in the case of a mere holding or investment company, the accumulated earnings credit provided by section 535(c)(3)) allowable for such short period shall be the amount computed by dividing (a) the amount (if any) by which $100,000 exceeds the aggregate of the accumulated earnings and profits of the corporations, which are members of the affiliated group on the last day of such short period, as of the close of their taxable years preceding the taxable year which includes the last day of such short period, by (b) the number of such members on the last day of such short period;

(v) The deduction allowable under section 615(a) for such short period shall be limited to an amount equal to $100,000 divided by the number of corporations which are members of the affiliated group on the last day of such short period;

(vi) If the expenditures to which section 615(a) applies which are paid or incurred by such corporation during such short period would, when added to the aggregate of the amounts deducted or deferred (in taxable years ending before the last day of such short period) which are taken into account in applying the limitation of section 615(c) by corporations which are members of the affiliated group on the last day of such short period exceed $400,000, then section 615 shall not apply to any such expenditure so paid or incurred by such corporation to the extent such expenditure would exceed an amount equal to (*a*) the amount (if any) by which $400,000 exceeds the aggregate of the amounts so deducted or deferred in such taxable years (computed as if each member filed a separate return), divided by (*b*) the number of corporations in the group which have taxable years ending on such last day;

(vii) If such corporation is a life insurance company taxable under section 802, the small business deduction under sections 804(a)(4) and 809(d)(10) shall not exceed an amount equal to (*a*) $25,000, divided by (*b*) the number of life insurance companies taxable under section 802 which are members of the affiliated group on the last day of such short period; and

(viii) The exemption from estimated tax (for purposes of estimated tax filing requirements under section 6016 and the addition to tax under section 6655 for failure to pay estimated tax) for such short period shall be an amount equal to $100,000 divided by the number of corporations which are members of the affiliated group on the last day of such short period.

[T.D. 6992, 34 FR 821, Jan. 18, 1969, as amended by T.D. 7376, 40 FR 42745, Sept. 16, 1975]

§ 1.245–1 Dividends received from certain foreign corporations.

(a) *General rule.* (1) A corporation is allowed a deduction under section 245(a) for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under chapter 1 of the Code if, for an uninterrupted period of not less than 36 months ending with the close of the foreign corporation's taxable year in which the dividends are paid, (i) the foreign corporation is engaged in trade or business in the United States, and (ii) 50 percent or more of the foreign corporation's entire gross income is effectively connected with the conduct of a trade or business in the United States by that corporation. If the foreign corporation has been in existence less than 36 months as of the close of the taxable year in which the dividends are paid, then the applicable uninterrupted period to be taken into consideration in lieu of the uninterrupted period of 36 or more months is the entire period such corporation has been in existence as of the close of such taxable year. An uninterrupted period which satisfied the twofold requirement with respect to business activity and gross income may start at a date later than the date on which the foreign corporation first commenced an uninterrupted period of engaging in trade or business within the United States, but the applicable uninterrupted period is in any event the longest uninterrupted period which satisfies such twofold requirement. The deduction under section 245(a) is allowable to any corporation, whether foreign or domestic, receiving dividends from a distributing corporation which meets the requirements of that section.

(2) Any taxable year of a foreign corporation which falls within the uninterrupted period described in section 245(a)(2) shall not be taken into account in applying section 245(a)(2) and this paragraph if the 100 percent dividends received deduction would be allowable under paragraph (b) of this section, whether or not in fact allowed, with respect to any dividends payable, whether or not in fact paid, out of the earnings and profits of such foreign corporation for that taxable year. Thus, in such case the foreign corporation shall be treated as having no earnings and profits for that taxable year for purposes of determining the dividends received deduction allowable under section 245(a) and this paragraph. However, that taxable year may be taken into account for purposes of determining whether the foreign corporation meets the requirements of section 245(a) that, for the uninterrupted period specified therein, the foreign corporation is engaged in trade or business in the United States and meets the 50 percent gross income requirement.

(b) *Dividends from wholly owned foreign subsidiaries.* (1) A domestic corporation is allowed a deduction under section 245(b) for any taxable year beginning after December 31, 1966, for dividends received from a foreign corporation (other than a foreign personal holding company as defined in section 552) which is subject to taxation under Chapter 1 of the Code if:

(i) The domestic corporation owns either directly or indirectly all of the outstanding stock of the foreign corporation during the entire taxable year of the domestic corporation in which the dividends are received, and

(ii) The dividends are paid out of earnings and profits of a taxable year of the foreign corporation during which (*a*) the domestic corporation receiving the dividends owns directly or indirectly throughout such year all of the outstanding stock of the foreign corporation, and (*b*) all of the gross income of the foreign corporation from all sources is effectively connected for that year with the conduct of a trade or business in the United States by that corporation.

(2) The deduction allowed by section 245(b) does not apply if an election under section 1562, relating to the privilege of a controlled group of corporations to elect multiple surtax exemptions, is effective for either the taxable year of the domestic corporation in which the dividends are received or the taxable year of the foreign corporation out of the earnings and profits of which the dividends are paid.

(c) *Rules of application.* (1) Except as provided in section 246, the deduction provided by section 245 for any taxable year is the sum of the amounts computed under paragraphs (1) and (2) of section 245(a) plus, in the case of a domestic corporation for any taxable year beginning after December 31, 1966, the sum of the amounts computed under section 245(b)(2).

(2) To the extent that a dividend received from a foreign corporation is treated as a dividend from a domestic corporation in accordance with section 243(d) and §1.243–3, it shall not be treated as a dividend received from a foreign corporation for purposes of this section.

(3) For purposes of section 245 (a) and (b), the amount of a distribution shall be determined under subparagraph (B) (without reference to subparagraph (C)) of section 301(b)(1).

(4) In determining from what year's earnings and profits a dividend is treated as having been distributed for purposes of this section, the principles of paragraph (a) of §1.316–2 shall apply. A dividend shall be considered to be distributed, first, out of the earnings and profits of the taxable year which includes the date the dividend is distributed, second, out of the earnings and profits accumulated for the immediately preceding taxable year, third, out of the earnings and profits accumulated for the second preceding taxable year, etc. A deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account. If there are no accumulated earnings and profits in an earnings and profits account because of a deficit incurred in a prior year, such deficit must be restored before earnings and profits can be accumulated in a subsequent accounting year. See also paragraph (c) of §1.243–3 and paragraph (a)(6) of §1.243–4.

(5) For purposes of this section the gross income of a foreign corporation for any period before its first taxable year beginning after December 31, 1966, which is from sources within the United States shall be treated as gross income which is effectively connected for that period with the conduct of a trade or business in the United States by that corporation.

(6) For the determination of the source of income and the income which is effectively connected with the conduct of a trade or business in the United States, see sections 861 through 864, and the regulations thereunder.

(d) *Illustrations.* The application of this section may be illustrated by the following examples:

Example 1. Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by Corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1943, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1954. Corporation A had accumulated earnings and profits of $50,000 immediately prior to January 1, 1943, and had earnings and profits of $10,000 for each taxable year during the uninterrupted period from January 1, 1943, through December 31, 1954. It derived for the period from January 1, 1943, through December 31, 1953, 90 percent of its gross income from sources within the United States and in 1954 derived 95 percent of its gross income from sources within the United States. During the calendar years 1943, 1944, 1945, 1946, and 1947 Corporation A distributed in each year $15,000; during the calendar years 1948, 1949, 1950, 1951, 1952, and 1953 it distributed in each year $5,000; and during the year 1954, $50,000. An analysis of the accumulated earnings and profits under the above statement of facts discloses that at December 31, 1953, the accumulation amounted to $55,000, of which $25,000 was accumulated prior to the ''uninterrupted period'' and $30,000 was accumulated during the uninterrupted period. (See section 316(a) and paragraph (c) of this section.) For 1954 a deduction under section 245 of $31,025 ($8,075 on 1954 earnings of the foreign corporation, plus $22,950 from the $30,000 accumulation at December 31, 1953) for dividends received from a foreign corporation is allowable to Corporation B with respect to the $50,000 received from Corporation A, computed as follows:

(i) $8,075, which is $8,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of the $10,000 of earnings and profits of the taxable year) multiplied by 95 percent (the portion of the gross income of Corporation A derived during the taxable year 1954 from sources within the United States), plus

(ii) $22,950, which is $25,500 (85 percent—the percent specified in section 243 for the calendar year 1954—of $30,000, the part of the earnings and profits accumulated after the beginning of the uninterrupted period) multiplied by 90 percent (the portion of the gross income of Corporation A derived from sources within the United States during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example 2. If in *Example 1,* Corporation A for the taxable year 1954 had incurred a deficit of $10,000 (shown to have been incurred before December 31) the amount of the earnings and profits accumulated after the beginning of the uninterrupted period would be $20,000. If Corporation A had distributed $50,000 on December 31, 1954, the deduction under section 245 for dividends received from a foreign corporation allowable to Corporation B for 1954 would be $15,300, computed by multiplying $17,000 (85 percent—the percent specified in section 243 for the calendar year 1954—of $20,000 earnings and profits accumulated after the beginning of the uninterrupted period) by 90 percent (the portion of the gross income of Corporation A derived from United States sources during that portion of the uninterrupted period ending at the beginning of the taxable year 1954).

Example 3. Corporation A (a foreign corporation filing its income tax returns on a calendar year basis) whose stock is 100 percent owned by corporation B (a domestic corporation filing its income tax returns on a calendar year basis) for the first time engaged in trade or business within the United States on January 1, 1960, and qualifies under section 245 for the entire period beginning on that date and ending on December 31, 1963. In 1963, A derived 75 percent of its gross income from sources within the United States. A's earnings and profits for 1963 (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year) are $200,000. On December 31, 1963, corporation A distributes to corporation B 100 shares of corporation C stock which have an adjusted basis in A's hands of $40,000 and a fair market value of $100,000. For purposes of computing the deduction under section 245 for dividends received from a foreign corporation, the amount of the distribution is $40,000. B is allowed a deduction under section 245 of $25,500, i.e., $34,000 ($40,000 multiplied by 85 percent, the percent specified in section 243 for 1963), multiplied by 75 percent (the portion of the gross income of corporation A derived during 1963 from sources within the United States).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6752, 29 FR 12701, Sept. 9, 1964; T.D. 6830; 30 FR 8046, June 23, 1965; T.D. 7293, 38 FR 32793, Nov. 28, 1973]

§§ 1.245A–1—1.245A–4 [Reserved]

§ 1.245A–5 Limitation of section 245A deduction and section 954(c)(6) exception.

(a) *Overview.* This section provides rules that limit a deduction under section 245A(a) to the portion of a dividend that exceeds the ineligible amount of such dividend or the applicability of section 954(c)(6) when a portion of a dividend is paid out of an extraordinary disposition account or when an extraordinary reduction occurs. Paragraph (b) of this section provides rules regarding ineligible amounts. Paragraph (c) of this section provides rules for determining ineligible amounts attributable to an extraordinary disposition. Paragraph (d) of this section provides rules that limit the application of section 954(c)(6) when one or more section 245A shareholders of a lower-tier CFC have an extraordinary disposition account. Paragraph (e) of this section provides rules for determining ineligible amounts attributable to an extraordinary reduction. Paragraph (f) of this section provides rules that limit the application of section 954(c)(6) when a lower-tier CFC has an extraordinary reduction amount. Paragraph (g) of this section provides special rules for purposes of applying this section. Paragraph (h) of this section provides an anti-abuse rule. Paragraph (i) of this section provides definitions. Paragraph (j) of this section provides examples illustrating the application of this section. Paragraph (k) of this section provides the applicability date of this section.

(b) *Limitation of deduction under section 245A*—(1) *In general.* A section 245A shareholder is allowed a section 245A deduction for any dividend received from an SFC (provided all other applicable requirements are satisfied) only to the extent that the dividend exceeds the ineligible amount of the dividend. See paragraphs (j)(2), (4), and (5) of this section for examples illustrating the application of this paragraph (b)(1).

(2) *Definition of ineligible amount.* The term *ineligible amount* means, with respect to a dividend received by a section 245A shareholder from an SFC, an amount equal to the sum of—

(i) 50 percent of the extraordinary disposition amount (as determined under paragraph (c) of this section); and

(ii) The extraordinary reduction amount (as determined under paragraph (e) of this section).

(c) *Rules for determining extraordinary disposition amount*—(1) *Definition of extraordinary disposition amount.* The term *extraordinary disposition amount* means the portion of a dividend received by a section 245A shareholder from an SFC that is paid out of the extraordinary disposition account with respect to the section 245A shareholder. See paragraph (j)(2) of this section for an example illustrating the application of this paragraph (c).

(2) *Determination of portion of dividend paid out of extraordinary disposition account*—(i) *In general.* For purposes of determining the portion of a dividend received by a section 245A shareholder from an SFC that is paid out of the extraordinary disposition account with respect to the section 245A shareholder, the following rules apply—

(A) The dividend is first considered paid out of non-extraordinary disposition E&P with respect to the section 245A shareholder; and

(B) The dividend is next considered paid out of the extraordinary disposition account to the extent of the section 245A shareholder's extraordinary disposition account balance.

(ii) *Definition of non-extraordinary disposition E&P.* The term *non-extraordinary disposition E&P* means, with respect to a section 245A shareholder and an SFC, an amount of earnings and profits of the SFC equal to the excess, if any, of—

(A) The product of—

(*1*) The amount of the SFC's earnings and profits described in section 959(c)(3), determined as of the end of the SFC's taxable year (for purposes of paragraph (c)(2)(ii) of this section, without regard to distributions during the taxable year other than as provided in this paragraph (c)(2)(ii)(A)(*1*)), but, if during the taxable year the SFC pays more than one dividend, reduced (but not below zero) by the amounts of any dividends paid by the SFC earlier in the taxable year; and

(*2*) The percentage of the stock (by value) of the SFC that the section 245A shareholder owns directly or indirectly immediately before the distribution; over

(B) The balance of the section 245A shareholder's extraordinary disposition account with respect to the SFC, determined immediately before the distribution.

(3) *Definitions with respect to extraordinary disposition accounts*—(i) *Extraordinary disposition account*—(A) *In general.* The term *extraordinary disposition account* means, with respect to a section 245A shareholder of an SFC, an account, the balance of which is equal to the product of the extraordinary disposition ownership percentage and the extraordinary disposition E&P, reduced (but not below zero) by the prior extraordinary disposition amount and as provided in §1.245A–7 or §1.245A–8, and adjusted under paragraph (c)(4) of this section, as applicable. An extraordinary disposition account is maintained in the same functional currency as the extraordinary disposition E&P.

(B) *Extraordinary disposition ownership percentage.* The term *extraordinary disposition ownership percentage* means the percentage of stock (by value) of an SFC that a section 245A shareholder owns directly or indirectly at the beginning of the disqualified period or, if later, on the first day during the disqualified period on which the SFC is a CFC, regardless of whether the section 245A shareholder owns directly or indirectly such stock of the SFC on the date of an extraordinary disposition giving rise to extraordinary disposition E&P; if not, see paragraph (c)(4) of this section.

(C) *Extraordinary disposition E&P.* The term *extraordinary disposition E&P* means an amount of earnings and profits of an SFC equal to the sum of the net gain recognized by the SFC with respect to specified property in each extraordinary disposition. In the case of an extraordinary disposition with respect to the SFC arising as a result of a disposition of specified property by a specified entity (other than a foreign corporation), an interest of which is owned directly or indirectly (through one or more other specified entities that are not foreign corporations) by the SFC, the net gain taken into account for purposes of the preceding sentence is the SFC's distributive share of the net gain recognized by the specified entity with respect to the specified property.

(D) *Prior extraordinary disposition amount*—(*1*) *General rule*. The term *prior extraordinary disposition amount* means, with respect to an SFC and a section 245A shareholder, the sum of the extraordinary disposition amount of each prior dividend received by the section 245A shareholder from the SFC by reason of paragraph (c)(1) of this section and 200 percent of the sum of the amounts included in the section 245A shareholder's gross income under section 951(a) by reason of paragraph (d) of this section (in the case in which the SFC is, or has been, a lower-tier CFC). A section 245A shareholder's prior extraordinary disposition amount also includes—

(*i*) A prior dividend received by the section 245A shareholder from the SFC to the extent not an extraordinary reduction amount and to the extent the dividend would have been an extraordinary disposition amount but for the failure of the dividend to qualify for the section 245A deduction by reason of one or more of the following: Application of section 245A(e); the recipient domestic corporation does not satisfy the holding period requirement of section 246; or the recipient domestic corporation is not a United States shareholder with respect to the foreign corporation from whose earnings and profits the dividend is sourced;

(*ii*) The portion of a prior dividend (to the extent not a tiered extraordinary disposition amount by reason of paragraph (d) of this section) received by an upper-tier CFC from the SFC that by reason of section 245A(e) or being properly allocable to subpart F income of the SFC for the taxable year of the dividend pursuant to section 954(c)(6)(A) was included in the upper-tier CFC's foreign personal holding company income and was included in gross income by the section 245A shareholder under section 951(a) but would have been a tiered extraordinary disposition amount by reason of paragraph (d) of this section had paragraph (d) applied to the dividend;

(*iii*) If a prior dividend received by an upper-tier CFC from a lower-tier CFC gives rise to a tiered extraordinary disposition amount with respect to the section 245A shareholder by reason of paragraph (d) of this section, the qualified portion; and

(*iv*) 200 percent of an amount included in the gross income of a domestic corporation under section 951(a)(1)(B) with respect to a CFC for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent so included by reason of the application of this section to the hypothetical distribution described in §1.956–1(a)(2), or to the extent the amount would have been so included by reason of the application of this section to the hypothetical distribution but for the application of section 245A(e) or the holding period requirement in section 246 to the hypothetical distribution.

(*2*) *Definition of qualified portion*—(*i*) *In general*. The term *qualified portion* means, with respect to a tiered extraordinary disposition amount of a section 245A shareholder and a lower-tier CFC, 200 percent of the portion of the disqualified amount with respect to the tiered extraordinary disposition amount equal to the sum of the amounts included in gross income by each U.S. tax resident under section 951(a) in the taxable year in which the tiered extraordinary disposition amount arose with respect to the lower-tier CFC by reason of paragraph (d) of this section. For purposes of the preceding sentence, the reference to a U.S. tax resident does not include any section 245A shareholder with a tiered extraordinary disposition amount with respect to the lower-tier CFC.

(*ii*) *Determining a qualified portion if multiple section 245A shareholders have tiered extraordinary disposition amounts*. For the purposes of applying paragraph (c)(3)(i)(D)(*2*)(*i*) of this section, if more than one section 245A shareholder has a tiered extraordinary disposition amount with respect to a dividend received by an upper-tier CFC from a lower-tier CFC, then the qualified portion with respect to each section 245A shareholder is equal to the amount described in paragraph (c)(3)(i)(D)(*2*)(*i*) of this section, without regard to this paragraph (c)(3)(i)(D)(*2*)(*ii*), multiplied by a fraction, the numerator of which is the section 245A shareholder's tiered extraordinary disposition amount with respect to the lower-tier CFC and the denominator of which is the sum of the tiered extraordinary disposition amounts with respect to each section 245A shareholder and the lower-tier CFC.

(ii) *Extraordinary disposition*—(A) *In general*. Except as provided in paragraph (c)(3)(ii)(E) of this section, the term *extraordinary disposition* means, with respect to an SFC, any disposition of specified property by the SFC on a date on which it was a CFC and during the SFC's disqualified period to a related party if the disposition occurs outside of the ordinary course of the SFC's activities. An extraordinary disposition also includes a disposition during the disqualified period on a date on which the SFC is not a CFC if there is a plan, agreement, or understanding involving a section 245A shareholder to cause the SFC to recognize gain that would give rise to an extraordinary disposition if the SFC were a CFC.

(B) *Facts and circumstances*. A determination as to whether a disposition is undertaken outside of the ordinary course of an SFC's activities is made on the basis of facts and circumstances, taking into account whether the transaction is consistent with the SFC's past activities, including with respect to quantity and frequency. In addition, a disposition of specified property by an SFC to a related party may be considered outside of the ordinary course of the SFC's activities notwithstanding that the SFC regularly disposes of property of the same type of, or similar to, the specified property to persons that are not related parties.

(C) *Per se rules*—(*1*) *In general*. Even if a disposition would otherwise be considered to be undertaken in the ordinary course of an SFC's activities under the requirements of paragraph (c)(3)(ii)(B) of this section, that disposition is treated as occurring outside of the ordinary course of an SFC's activities if the disposition is undertaken with a principal purpose of generating earnings and profits during the disqualified period or, except as provided in paragraph (c)(3)(ii)(C)(*2*) of this section, if the disposition is of intangible property, as defined in section 367(d)(4).

(*2*) *Exception to the per se rule for certain property*—(*i*) *Exception*. Paragraph (c)(3)(ii)(C)(*1*) of this section does not apply to a disposition of intangible property that is not described in section 367(d)(4)(C) or (F), provided that the property is transferred to a related person during the disqualified period with a reasonable expectation that the related person will resell the property to an unrelated customer within one year. Subject to paragraph (c)(3)(ii)(C)(*2*)(*ii*) of this section, a disposition of intangible property that satisfies the requirements of this paragraph (c)(3)(ii)(C)(*2*)(*i*) is determined to be within or without the ordinary course of an SFC's activities based on the test described in paragraph (c)(3)(ii)(B) of this section.

(*ii*) *Facts and circumstances presumption for property described in section 367(d)(4)(A)*. Notwithstanding paragraph (c)(3)(ii)(B) of this section, any disposition described in paragraph (c)(3)(ii)(C)(*2*)(*i*) of this section of a copyright right within the meaning of §1.861–18 or of intangible property described in section 367(d)(4)(A) is presumed to take place outside of the ordinary course of an SFC's activities for purposes of paragraph (c)(3)(ii)(A) of this section. The presumption in the preceding sentence may be rebutted only if the taxpayer can show that the facts and circumstances clearly establish that the disposition took place in the ordinary course of the SFC's activities.

(D) *Treatment of dispositions by certain specified entities*. For purposes of paragraph (c)(3)(ii)(A) of this section, an extraordinary disposition with respect to an SFC includes a disposition by a specified entity other than a foreign corporation, provided that immediately before or immediately after the disposition the specified entity is a related party with respect to the SFC, the SFC directly or indirectly (through one or more other specified entities other than foreign corporations) owns an interest in the specified entity, and the disposition would have otherwise qualified as an extraordinary disposition had the specified entity been a foreign corporation.

(E) *De minimis exception to extraordinary disposition.* If the sum of the net gain recognized by an SFC with respect to specified property in all dispositions otherwise described in paragraph (c)(3)(ii)(A) of this section does not exceed the lesser of $50 million or 5 percent of the gross value of all of the SFC's property held immediately before the beginning of its disqualified period, then no disposition of specified property by the SFC is an extraordinary disposition.

(iii) *Disqualified period.* The term *disqualified period* means, with respect to an SFC that is a CFC on any day during the taxable year that includes January 1, 2018, the period beginning on January 1, 2018, and ending as of the close of the taxable year of the SFC, if any, that begins before January 1, 2018, and ends after December 31, 2017.

(iv) *Specified property.* The term *specified property* means any property if gain recognized with respect to such property during the disqualified period is not described in section 951A(c)(2)(A)(i)(I) through (V). If only a portion of the gain recognized with respect to property during the disqualified period is gain that is not described in section 951A(c)(2)(A)(i)(I) through (V), then a portion of the property is treated as specified property in an amount that bears the same ratio to the value of the property as the amount of gain not described in section 951A(c)(2)(A)(i)(I) through (V) bears to the total amount of gain recognized with respect to such property during the disqualified period. Specified property is also property with respect to which a loss was recognized during the disqualified period if the loss is properly allocable to income not described in section 951A(c)(2)(A)(i)(I) through (V) under the principles of section 954(b)(5) (specified loss). If only a portion of the loss recognized with respect to property during the disqualified period is specified loss, then a portion of the property is treated as specified property in an amount that bears the same ratio to the value of the property as the amount of specified loss bears to the total amount of loss recognized with respect to such property during the disqualified period.

(4) *Successor rules for extraordinary disposition accounts.* This paragraph (c)(4) applies with respect to an extraordinary disposition account upon certain direct or indirect transfers of stock of an SFC by a section 245A shareholder.

(i) *Another section 245A shareholder succeeds to all or portion of account.* Except as provided in paragraph (c)(4)(vi) of this section, paragraphs (c)(4)(i)(A) through (D) of this section apply when a section 245A shareholder of an SFC (the *transferor*) transfers directly or indirectly a share of stock (or a portion of a share of stock) of the SFC that it owns directly or indirectly (the share or portion thereof, a *transferred share*).

(A) If immediately after the transfer (taking into account all transactions related to the transfer) another person is a section 245A shareholder of the SFC, then such other person's extraordinary disposition account with respect to the SFC is increased by the person's proportionate share of the amount allocated to the transferred share.

(B) For purposes of paragraph (c)(4)(i)(A) of this section, the amount allocated to a transferred share is equal to the product of—

(*1*) The balance of the transferor's extraordinary disposition account with respect to the SFC, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends and before the application of this paragraph (c)(4)(i)(B); and

(*2*) A fraction, the numerator of which is the value of the transferred share and the denominator of which is the value of all of the stock of the SFC that the transferor owns directly or indirectly immediately before the transfer.

(C) For purposes of paragraph (c)(4)(i)(A) of this section, a person's proportionate share of the amount allocated to a transferred share under paragraph (c)(4)(i)(B) of this section is equal to the product of—

(*1*) The amount allocated to the share; and

(*2*) The percentage of the share (by value) that the person owns directly or indirectly immediately after the transfer (taking into account all transactions related to the transfer).

(D) The transferor's extraordinary disposition account with respect to the SFC is decreased by the amount by which another person's extraordinary disposition account with respect to the SFC is increased pursuant to paragraph (c)(4)(i)(A) of this section.

(ii) *Certain section 381 transactions*—(A) *In general.* If assets of an SFC (the *acquired corporation*) are acquired by another SFC (the *acquiring corporation*) pursuant to a transaction described in section 381(a) in which the acquired corporation is the transferor corporation for purposes of section 381, then a section 245A shareholder's extraordinary disposition account with respect to the acquiring corporation is increased by the balance of its extraordinary disposition account with respect to the acquired corporation, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends and before the application of this paragraph (c)(4)(ii)(A).

(B) *Certain triangular asset reorganizations.* If, in a transaction described in paragraph (c)(4)(ii)(A) of this section, the section 245A shareholder receives stock of a domestic corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the domestic corporation's extraordinary disposition account with respect to the acquiring corporation is increased by the balance of the section 245A shareholder's extraordinary disposition account with respect to the acquired corporation, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends and before the application of this paragraph (c)(4)(ii)(B).

(iii) *Certain distributions involving section 355 or 356.* In the case of a transaction involving a distribution under section 355 (or so much of section 356 as it relates to section 355) by an SFC (the *distributing corporation*) of stock of another SFC (the *controlled corporation*), a section 245A shareholder's extraordinary disposition account with respect to the distributing corporation is attributed to (and treated as) an extraordinary disposition account with respect to the controlled corporation in a manner similar to how earnings and profits of the distributing corporation and the controlled corporation are adjusted under §1.312–10. To the extent that a section 245A shareholder's extraordinary disposition account with respect to the distributing CFC is not so attributed to (and treated as) an extraordinary disposition account with respect to the controlled corporation, the extraordinary disposition account remains as an extraordinary disposition account with respect to the distributing corporation.

(iv) *Transfer of all of the stock of the SFC owned by a section 245A shareholder*—(A) *In general.* If, in a transaction described in paragraph (c) of this section, a section 245A shareholder of an SFC transfers directly or indirectly all of the stock of the SFC that it owns directly or indirectly, then, except as provided in paragraph (c)(4)(iv)(B) of this section, any remaining balance of the section 245A shareholder's extraordinary disposition account that is not allocated or attributed under paragraph (c) of this section is eliminated and therefore not taken into account by any person.

(B) *Related party retains the extraordinary distribution account.* If any related party with respect to the section 245A shareholder described in paragraph (c)(4)(iv)(A) of this section is a section 245A shareholder with respect to the SFC immediately after the transfer (taking into account all transactions related to the transfer), then the remaining balance of the section 245A shareholder's extraordinary disposition account with respect to the SFC is added to the related party's extraordinary disposition account. If multiple related parties are section 245A shareholders of the SFC, then the remaining balance of the extraordinary disposition account is allocated between the related parties in proportion to the value of the stock of the SFC that they own directly or indirectly immediately after the transfer (taking into account all transactions related to the transfer).

(v) *Effect of section 338(g) election*—(A) *In general*. Except as provided in paragraph (c)(4)(v)(B) of this section, if an election under section 338(g) is made with respect to a qualified stock purchase (as defined in section 338(d)(3)) of stock of an SFC, then a section 245A shareholder's extraordinary disposition account with respect to the old target (as defined in §1.338–2(c)(17)) is not treated as (or attributed to) an extraordinary disposition account with respect to the new target (as defined in §1.338–2(c)(17)). Accordingly, the remaining balance of the old target's extraordinary disposition account is eliminated and is not thereafter taken into account by any person.

(B) *Special rules regarding carryover foreign target stock*. If an election under section 338(g) is made with respect to a qualified stock purchase (as described in section 338(d)(3)) of stock of an SFC and there are one or more shares of carryover foreign target stock (''FT stock'') (as described in §1.338–9(b)(3)(i)), then the following rules apply as to a section 245A shareholder of the new target that after the qualified stock purchase directly or indirectly owns carryover FT stock (such shareholder, the *carryover FT stock shareholder*):

(*1*) In a case in which before the qualified stock purchase the carryover FT stock shareholder directly or indirectly owned carryover FT stock, the carryover FT stock shareholder's extraordinary disposition account with respect to the old target, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends, is treated as its extraordinary disposition account with respect to the new target.

(*2*) In a case in which before the qualified stock purchase the carryover FT stock shareholder did not directly or indirectly own carryover FT stock, but the stock retains its character as carryover FT stock (taking into account §1.338–9(b)(3)(vi)), a ratable portion of each section 245A shareholder's extraordinary disposition account with respect to the old target, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends, is treated as the carryover FT stock shareholder's extraordinary disposition account with respect to the new target, based on the value of the carryover FT stock that the carryover FT stock shareholder owns directly or indirectly after the qualified stock purchase relative to the value of all of the stock of the new target.

(vi) *Certain transfers described in §1.1248–8(a)(1)*—(A) *In general*. If a person transfers stock of an SFC with respect to which a section 245A shareholder has an extraordinary disposition account to a foreign acquiring corporation in a transaction described §1.1248–8(a)(1) (other than a transfer that is also described in §1.1248(f)–1(b)(2) or (3)) in which stock of a foreign corporation is received by the transferor, then, except in the case in which the transfer is also described in paragraph (c)(4)(ii) or (iii) of this section, the section 245A shareholder's extraordinary disposition account is not adjusted under this paragraph (c)(4).

(B) *Certain transfers described in §1.1248(f)–1(b)*. In the case of a transfer directly or indirectly of stock of an SFC by a section 245A shareholder described in §1.1248(f)–1(b)(2) or (3), but which does not result in an income inclusion, in whole or in part, by reason of §1.1248–2, the section 245A shareholder's extraordinary disposition account with respect to the SFC, determined after any reduction pursuant to paragraph (c)(3) of this section by reason of dividends and before the application of this paragraph (c)(4)(vi)(B), is allocated and adjusted in the same manner as under paragraph (c)(4)(i) of this section, except that, for purposes of applying paragraphs (c)(4)(i)(B) and (C) of this section, stock of the SFC that is owned directly or indirectly by persons who are not section 1248 shareholders (as defined in §1.1248(f)–1(c)(12)) is disregarded.

(vii) *Anti-abuse rule*. Pursuant to paragraph (h) of this section, if a principal purpose of a transaction or series of transactions is to shift to another person, or to avoid, an amount of a section 245A shareholder's extraordinary disposition account with respect to an SFC or otherwise avoid the purposes of this section, then appropriate adjustments are made for purposes of this section, including disregarding the transaction or series of transactions. A principal purpose described in the preceding sentence is deemed to exist if stock of an SFC is directly or indirectly acquired by one of more section 245A shareholders within one year of a transaction or transactions to which paragraph (c)(4)(iv)(A) of this section would otherwise apply.

(d) *Limitation of amount eligible for section 954(c)(6) when there is an extraordinary disposition account with respect to a lower-tier CFC*—(1) *In general.* If an upper-tier CFC receives a dividend from a lower-tier CFC, then the dividend is eligible for the exception to foreign personal holding company income under section 954(c)(6) (provided all other applicable requirements are satisfied) with respect to the portion of the dividend that exceeds the disqualified amount. With respect to the portion of the dividend that does not exceed the disqualified amount, the exception to foreign personal holding company income under section 954(c)(6) is allowed (provided all other applicable requirements are satisfied) only for the amount equal to 50 percent of the portion of the dividend that does not exceed the disqualified amount. The disqualified amount is the quotient of the amounts described in paragraphs (d)(1)(i) and (ii) of this section.

(i) The sum of each section 245A shareholder's tiered extraordinary disposition amount with respect to the lower-tier CFC.

(ii) The percentage of stock of the upper-tier CFC (by value) owned, in the aggregate, by U.S. tax residents that include in gross income their pro rata share of the upper-tier CFC's subpart F income under section 951(a) on the last day of the upper-tier CFC's taxable year. If a U.S. tax resident is a direct or indirect partner in a domestic partnership that is a United States shareholder of the upper-tier CFC, the amount of stock owned by the U.S. tax resident for purposes of the preceding sentence is determined under the principles of paragraph (g)(3) of this section.

(2) *Definition of tiered extraordinary disposition amount*—(i) *In general.* The term *tiered extraordinary disposition amount* means, with respect to a dividend received by an upper-tier CFC from a lower-tier CFC and a section 245A shareholder, the portion of the dividend that would be an extraordinary disposition amount if the section 245A shareholder received as a dividend its pro rata share of the dividend from the lower-tier CFC. The preceding sentence does not apply to an amount treated as a dividend received by an upper-tier CFC from a lower-tier CFC by reason of section 964(e)(4) (in such case, see paragraphs (b)(1) and (g)(2) of this section).

(ii) *Section 245A shareholder's pro rata share of a dividend received by an upper-tier CFC.* For the purposes of paragraph (d)(2)(i) of this section, a section 245A shareholder's pro rata share of the amount of a dividend received by an upper-tier CFC from a lower-tier CFC equals the amount by which the dividend would increase the section 245A shareholder's pro rata share of the upper-tier CFC's subpart F income under section 951(a)(2) and §1.951–1(b) and (e) if the dividend were included in the upper-tier CFC's foreign personal holding company income under section 951(a)(1), determined without regard to section 952(c) and as if the upper-tier CFC had no deductions properly allocable to the dividend under section 954(b)(5).

(e) *Extraordinary reduction amount*—(1) *In general.* Except as provided in paragraph (e)(3) of this section, the term *extraordinary reduction amount* means, with respect to a dividend received by a controlling section 245A shareholder from a CFC during a taxable year of the CFC ending after December 31, 2017, in which an extraordinary reduction occurs with respect to the controlling section 245A shareholder's ownership of the CFC, the lesser of the amounts described in paragraph (e)(1)(i) or (ii) of this section. *See* paragraphs (j)(4) through (6) of this section for examples illustrating the application of this paragraph (e).

(i) The amount of the dividend.

(ii) The amount equal to the sum of the controlling section 245A shareholder's pre-reduction pro rata share of the CFC's subpart F income (as defined in section 952(a)) and tested income (as defined in section 951A(c)(2)(A)) for the taxable year, reduced, but not below zero, by the prior extraordinary reduction amount.

(2) *Rules regarding extraordinary reduction amounts*—(i) *Extraordinary reduction*—(A) *In general.* Except as provided in paragraph (e)(2)(i)(C) of this section, an *extraordinary reduction* occurs, with respect to a controlling section 245A shareholder's ownership of a CFC during a taxable year of the CFC, if either of the conditions described in paragraph (e)(2)(i)(A)(*1*) or (*2*) of this section is satisfied. See paragraphs (j)(4) and (5) of this section for examples illustrating an extraordinary reduction.

(*1*) The condition of this paragraph (e)(2)(i)(A)(*1*) requires that during the taxable year, the controlling section 245A shareholder transfers directly or indirectly (other than by reason of a transfer occurring pursuant to an exchange described in section 368(a)(1)(E) or (F)), in the aggregate, more than 10 percent (by value) of the stock of the CFC that the section 245A shareholder owns directly or indirectly as of the beginning of the taxable year of the CFC, provided the stock transferred, in the aggregate, represents at least 5 percent (by value) of the outstanding stock of the CFC as of the beginning of the taxable year of the CFC; or

(*2*) The condition of this paragraph (e)(2)(i)(A)(*2*) requires that, as a result of one or more transactions occurring during the taxable year, the percentage of stock (by value) of the CFC that the controlling section 245A shareholder owns directly or indirectly as of the close of the last day of the taxable year of the CFC is less than 90 percent of the percentage of stock (by value) that the controlling section 245A shareholder owns directly or indirectly on either of the dates described in paragraphs (e)(2)(i)(B)(*1*) and (*2*) of this section (such percentage, the *initial percentage*), provided the difference between the initial percentage and percentage at the end of the year is at least five percentage points.

(B) *Dates for purposes of the initial percentage.* For purposes of paragraph (e)(2)(i)(A)(*2*) of this section, the dates described in paragraphs (e)(2)(i)(B)(*1*) and (*2*) of this section are—

(*1*) The day of the taxable year on which the controlling section 245A shareholder owns directly or indirectly its highest percentage of stock (by value) of the CFC; and

(*2*) The day immediately before the first day on which stock was transferred directly or indirectly in the preceding taxable year in a transaction (or a series of transactions) occurring pursuant to a plan to reduce the percentage of stock (by value) of the CFC that the controlling section 245A shareholder owns directly or indirectly.

(C) *Transactions pursuant to which CFC's taxable year ends.* A controlling section 245A shareholder's direct or indirect transfer of stock of a CFC that but for this paragraph (e)(2)(i)(C) would give rise to an extraordinary reduction under paragraph (e)(2)(i)(A) of this section does not give rise to an extraordinary reduction if the taxable year of the CFC ends immediately after the transfer, provided that the controlling section 245A shareholder directly or indirectly owns the stock on the last day of such year. Thus, for example, if a controlling section 245A shareholder exchanges all the stock of a CFC pursuant to a complete liquidation of the CFC, the exchange does not give rise to an extraordinary reduction.

(ii) *Rules for determining pre-reduction pro rata share*—(A) *In general.* Except as provided in paragraph (e)(2)(ii)(B) of this section, the term *pre-reduction pro rata share* means, with respect to a controlling section 245A shareholder and the subpart F income or tested income of a CFC, the controlling section 245A shareholder's pro rata share of the CFC's subpart F income or tested income under section 951(a)(2) and §1.951–1(b) and (e) or section 951A(e)(1) and §1.951A–1(d)(1), respectively, determined based on the controlling section 245A shareholder's direct or indirect ownership of stock of the CFC immediately before the extraordinary reduction (or, if the extraordinary reduction occurs by reason of multiple transactions, immediately before the first transaction) and without regard to section 951(a)(2)(B) and §1.951–1(b)(1)(ii), but only to the extent that such subpart F income or tested income is not included in the controlling section 245A shareholder's pro rata share of the CFC's subpart F income or tested income under section 951(a)(2) and §1.951–

1(b) and (e) or section 951A(e)(1) and § 1.951A–1(d)(1), respectively.

(B) *Decrease in section 245A shareholder's pre-reduction pro rata share for amounts taken into account by U.S. tax resident.* A controlling section 245A shareholder's pre-reduction pro rata share of subpart F income or tested income of a CFC for a taxable year is reduced by an amount equal to the sum of the amounts by which each U.S. tax resident's pro rata share of the subpart F income or tested income is increased as a result of a transfer directly or indirectly of stock of the CFC by the controlling section 245A shareholder or an issuance of stock by the CFC (such an amount with respect to a U.S. tax resident, a *specified amount*), in either case, during the taxable year in which the extraordinary reduction occurs. For purposes of this paragraph (e)(2)(ii)(B), if there are extraordinary reductions with respect to more than one controlling section 245A shareholder during the CFC's taxable year, then a U.S. tax resident's specified amount attributable to an acquisition of stock from the CFC is prorated with respect to each controlling section 245A shareholder based on its relative decrease in ownership of the CFC. See paragraph (j)(5) of this section for an example illustrating a decrease in a section 245A shareholder's pre-reduction pro rata share for amounts taken into account by a U.S. tax resident.

(C) *Prior extraordinary reduction amount.* The term *prior extraordinary reduction amount* means, with respect to a CFC and section 245A shareholder and a taxable year of the CFC in which an extraordinary reduction occurs, the sum of the extraordinary reduction amount of each prior dividend received by the section 245A shareholder from the CFC during the taxable year. A section 245A shareholder's prior extraordinary reduction amount also includes—

(*1*) A prior dividend received by the section 245A shareholder from the CFC during the taxable year to the extent the dividend was not eligible for the section 245A deduction by reason of section 245A(e) or the holding period requirement of section 246 not being satisfied but would have been an extraordinary reduction amount had this paragraph (e) applied to the dividend;

(*2*) If the CFC is a lower-tier CFC for a portion of the taxable year during which the lower-tier CFC pays any dividend to an upper tier-CFC, the portion of a prior dividend received by an upper-tier CFC from the lower-tier CFC during the taxable year of the lower-tier CFC that, by reason of section 245A(e), was included in the upper-tier CFC's foreign personal holding company income and that by reason of section 951(a) was included in income of the section 245A shareholder, and that would have given rise to a tiered extraordinary reduction amount by reason of paragraph (f) of this section had paragraph (f) applied to the dividend of which the section 245A shareholder would have included a pro rata share of the tiered extraordinary reduction amount in income by reason of section 951(a); and

(*3*) If the CFC is a lower-tier CFC for a portion of the taxable year during which the lower-tier CFC pays any dividend to an upper-tier CFC, the sum of the portion of the tiered extraordinary reduction amount of each prior dividend received by an upper-tier CFC from the lower-tier CFC during the taxable year that is included in income of the section 245A shareholder by reason of section 951(a).

(3) *Exceptions*—(i) *Elective exception to close CFC's taxable year*—(A) *In general.* For a taxable year of a CFC in which an extraordinary reduction occurs with respect to a controlling section 245A shareholder and for which, absent this paragraph (e)(3)(i), there would be an extraordinary reduction amount or tiered extraordinary reduction amount greater than zero, no amount is considered an extraordinary reduction amount or tiered extraordinary reduction amount with respect to the controlling section 245A shareholder if each controlling section 245A shareholder elects, and each U.S. tax resident described in paragraph (e)(3)(i)(C)(*2*) of this section agrees, pursuant to this paragraph (e)(3)(i), to close the CFC's taxable year for all purposes of the Internal Revenue Code (and, therefore, as to all shareholders of the CFC) as of the end of the date on

which the extraordinary reduction occurs, or, if the extraordinary reduction occurs by reason of multiple transactions, as of the end of each date on which a transaction forming a part of the extraordinary reduction occurs. Because the determination as to whether there would be an extraordinary reduction amount or tiered extraordinary reduction amount greater than zero is made without regard to this paragraph (e)(3)(i), this determination is made without taking into account any elections that may be available, or other events that may occur, solely by reason of an election described in this paragraph (e)(3)(i), such as the application of section 954(b)(4) to a short taxable year created as a result of the election. If an election is made pursuant to this paragraph (e)(3)(i), all shareholders of the CFC that are a controlling section 245A shareholder or a U.S. tax resident described in paragraph (e)(3)(i)(C)(*2*) of this section must file their respective U.S. income tax and information returns consistently with the election. If each controlling section 245A shareholder elects to close the CFC's taxable year, that closing will be treated as a change in accounting period for purposes of the notice requirement in §1.964–1(c)(3)(iii), treating any controlling section 245A shareholders as controlling domestic shareholders for this purpose. However, the notice described in §1.964–1(c)(3)(iii) does not need to be provided to persons that are U.S. tax residents described in paragraph (e)(3)(i)(C) of this section. For purposes of applying this paragraph (e)(3)(i), a controlling section 245A shareholder that has an extraordinary reduction (or a transaction forming a part thereof) with respect to a CFC is treated as owning the same amount of stock it owned in the CFC immediately before the extraordinary reduction (or a transaction forming a part thereof) on the end of the date on which the extraordinary reduction occurs (or such transaction forming a part thereof occurs). To the extent that shares of a CFC are treated as owned by a controlling section 245A shareholder as of the close of the CFC's taxable year pursuant to the preceding sentence, such shares are treated as not being owned by any other person as of the close of the CFC's taxable year.

(B) *Allocation of foreign taxes.* If an election is made pursuant to this paragraph (e)(3) to close a CFC's taxable year and the CFC's taxable year under foreign law (if any) does not close at the end of the date on which the CFC's taxable year closes as a result of the election, foreign taxes paid or accrued with respect to such foreign taxable year are allocated between the period of the foreign taxable year that ends with, and the period of the foreign taxable year that begins after, the date on which the CFC's taxable year closes as a result of the election. If there is more than one date on which the CFC's taxable year closes as a result of the election, foreign taxes paid or accrued with respect to the foreign taxable year are allocated to all such periods. The allocation is made based on the respective portions of the taxable income of the CFC (as determined under foreign law) for the foreign taxable year that are attributable under the principles of §1.1502–76(b) to the periods during the foreign taxable year. Foreign taxes allocated to a period under this paragraph (e)(3)(i)(B) are treated as paid or accrued by the CFC as of the close of that period.

(C) *Time and manner of making election*—(*1*) *Election by controlling section 245A shareholder.* An election pursuant to this paragraph (e)(3) is made and effective if the statement described in paragraph (e)(3)(i)(D) of this section is timely filed (including extensions) by each controlling section 245A shareholder making the election with its original U.S. tax return for the taxable year in which the extraordinary reduction occurs. If a controlling section 245A shareholder is a member of a consolidated group (within the meaning of §1.1502–1(h)) and participates in the extraordinary reduction, the agent for such group (within the meaning of §1.1502–77(c)(1)) must file the election described in this paragraph (e)(3) on behalf of such member.

(*2*) *Binding agreement.* Before the filing of the statement described in paragraph (e)(3)(i)(D) of this section, each controlling section 245A shareholder must enter into a written, binding agreement with each U.S. tax resident that on the end of the date on which the extraordinary reduction occurs (or, if the extraordinary reduction occurs by reason of multiple transactions, each U.S. tax resident that on the end of each date on which a transaction forming a part of the extraordinary reduction occurs) owns directly or indirectly, without regard to the final two sentences of paragraph (e)(3)(i)(A) of this section, stock of the CFC and is a United States shareholder with respect to the CFC. In the case of a U.S. tax resident that owns stock of the CFC indirectly through one or more partnerships, the partnership that directly owns the stock of the CFC may enter into the binding agreement on behalf of the U.S. tax resident partner provided that, before the due date of the partner's original Federal income tax return, including extensions, the partner delegated the authority to the partnership to enter into the binding agreement pursuant to a written partnership agreement (within the meaning of §1.704–1(b)(2)(ii)(*h*)). The written, binding agreement must provide that each controlling section 245A shareholder will elect to close the taxable year of the CFC.

(*3*) *Transition rule.* In the case of an extraordinary reduction occurring before August 27, 2020, the statement described in paragraph (e)(3)(i)(D) of this section is considered timely filed if it is attached by each controlling section 245A shareholder to an original or amended return for the taxable year in which the extraordinary reduction occurs. In the case of an amended return, the statement is considered timely filed only if it is filed with an amended return no later than February 23, 2021.

(D) *Form and content of statement.* The statement required by paragraph (e)(3)(i)(C) of this section is to be titled ''Elective Section 245A Year-Closing Statement.'' The statement must—

(*1*) Identify (by name and tax identification number, if any) each controlling section 245A shareholder, each U.S tax resident described in paragraph (e)(3)(i)(C) of this section, and the CFC;

(*2*) State the date of the extraordinary reduction (or, if the extraordinary reduction includes transactions on more than one date, the dates of all such transactions) to which the election applies;

(*3*) State the filing controlling section 245A shareholder's pro rata share of the subpart F income, tested income, and foreign taxes described in section 960 with respect to the stock of the CFC subject to the extraordinary reduction, and, if applicable, the amount of earnings and profits attributable to such stock within the meaning of section 1248, as of the date of the extraordinary reduction;

(*4*) State that each controlling section 245A shareholder and each U.S tax resident described in paragraph (e)(3)(i)(C) of this section have entered into a written, binding agreement to elect to close the CFC's taxable year in accordance with paragraph (e)(3)(i)(C) of this section; and

(*5*) Be filed in the manner, if any, prescribed by forms, publications, or other guidance published in the Internal Revenue Bulletin.

(E) *Consistency requirements.* If multiple extraordinary reductions occur with respect to one or more controlling section 245A shareholders' ownership in a single CFC during one or more taxable years of the CFC, then to the extent those extraordinary reductions occur pursuant to a plan or series of related transactions, the election described in this paragraph (e)(3) section may be made only if it is made for all such extraordinary reductions with respect to the CFC for which there was an extraordinary reduction amount. Furthermore, if an extraordinary reduction occurs with respect to a controlling section 245A shareholders' ownership in one or more CFCs, then, to the extent those extraordinary reductions occur pursuant to a plan or series of related transactions, the election described in this paragraph (e)(3) may be made only if it is made for each extraordinary reduction for which there was an extraordinary reduction amount with respect to all of the CFCs that have the same or related (within the meaning of section 267(b) or 707(b)) controlling section 245A shareholders.

(ii) *De minimis subpart F income and tested income.* For a taxable year of a CFC in which an extraordinary reduction occurs, no amount is considered an extraordinary reduction amount (or, with respect to a lower-tier CFC, a tiered extraordinary reduction amount under paragraph (f) of this section) with respect to a controlling section 245A shareholder of the CFC if the sum of the CFC's subpart F income and tested income (as defined in section 951A(c)(2)(A)) for the taxable year does not exceed the lesser of $50 million or 5 percent of the CFC's total income for the taxable year.

(f) *Limitation of amount eligible for section 954(c)(6) where extraordinary reduction occurs with respect to lower-tier CFCs*—(1) *In general.* If an extraordinary reduction occurs with respect to a lower-tier CFC and an upper-tier CFC receives a dividend from the lower-tier CFC in the taxable year in which the extraordinary reduction occurs, then the dividend is eligible for the exception to foreign personal holding company income under section 954(c)(6) (provided all other applicable requirements are satisfied) only with respect to the portion of the dividend that exceeds the tiered extraordinary reduction amount. The preceding sentence does not apply to an amount treated as a dividend received by an upper-tier CFC by reason of section 964(e)(4) (in this case, see paragraphs (b)(1) and (g)(2) of this section). See paragraph (j)(7) of this section for an example illustrating the application of this paragraph (f)(1).

(2) *Definition of tiered extraordinary reduction amount.* The term *tiered extraordinary reduction amount* means, with respect to the portion of a dividend received by an upper-tier CFC from a lower-tier CFC during a taxable year of the lower-tier CFC, the amount of such dividend equal to the excess, if any, of—

(i) The product of—

(A) The sum of the amount of the subpart F income and tested income of the lower-tier CFC for the taxable year; and

(B) The percentage (by value) of stock of the lower-tier CFC owned (within the meaning of section 958(a)(2)) by the upper-tier CFC immediately before the extraordinary reduction (or the first transaction forming a part thereof); over

(ii) The following amounts—

(A) The sum of each U.S. tax resident's pro rata share of the lower-tier CFC's subpart F income and tested income under section 951(a) or 951A(a), respectively, that is attributable to shares of the lower-tier CFC owned (within the meaning of section 958(a)(2)) by the upper-tier CFC immediately prior to the extraordinary reduction (or the first transaction forming a part thereof), computed without the application of this paragraph (f);

(B) The sum of each prior tiered extraordinary reduction amount and sum of each amount included in an upper-tier CFC's subpart F income by reason of section 245A(e) with respect to prior dividends from the lower-tier CFC during the taxable year;

(C) The sum of each U.S. tax resident's pro rata share of an upper-tier CFC's subpart F income under section 951(a) and §1.951–1(e) that is attributable to dividends received from the lower-tier CFC in the taxable year of the extraordinary reduction that do not qualify for the exception to foreign personal holding company income under section 954(c)(6) because the dividends, or portions thereof, are properly allocable to subpart F income of the lower-tier CFC for the taxable year of the extraordinary reduction pursuant to section 954(c)(6)(A);

(D) The sum of the prior extraordinary reduction amounts (but, for this purpose, computed without regard to amounts described in paragraphs (e)(2)(ii)(C)(*2*) and (*3*) of this section) of each controlling section 245A shareholder with respect to shares of the lower-tier CFC that were owned by such controlling section 245A shareholder (including indirectly through a specified entity other than a foreign corporation) for a portion of the taxable year but are owned by an upper-tier CFC (including indirectly through a specified entity other than a foreign corporation) at the time of the distribution of the dividend; and

(E) The product of the amount described in paragraph (f)(2)(i)(B) of this section and the sum of the amounts of each U.S. tax resident's pro rata share of subpart F income and tested income for the taxable year under section 951(a) or 951A(a), respectively, attributable to shares of the lower-tier CFC directly or indirectly acquired by the U.S. tax resident from the lower-tier CFC during the taxable year.

(3) *Transition rule for computing tiered extraordinary reduction amount.* Solely for purposes of applying this paragraph (f) in taxable years of a lower-tier CFC beginning on or after January 1, 2018, and ending before June 14, 2019, a tiered extraordinary reduction amount is determined by treating the lower-tier CFC's subpart F income for the taxable year as if it were neither subpart F income nor tested income.

(g) *Special rules.* The rules in this paragraph (g) apply for purposes of this section.

(1) *Source of dividends.* A dividend received by any person is considered received directly by such person from the foreign corporation whose earnings and profits give rise to the dividend. Therefore, for example, if a section 245A shareholder sells or exchanges stock of an upper-tier CFC and the gain recognized on the sale or exchange is included in the gross income of the section 245A shareholder as a dividend under section 1248(a), then, to the extent the dividend is attributable under section 1248(c)(2) to the earnings and profits of a lower-tier CFC owned, within the meaning of section 958(a)(2), by the section 245A shareholder through the upper-tier CFC, the dividend is considered received directly by the section 245A shareholder from the lower-tier CFC.

(2) *Certain section 964(e) inclusions treated as dividends.* An amount included in the gross income of a section 245A shareholder under section 951(a)(1)(A) by reason of section 964(e)(4) is considered a dividend received by the section 245A shareholder directly from the foreign corporation whose earnings and profits give rise to the amount described in section 964(e)(1). Therefore, for example, if an upper-tier CFC sells or exchanges stock of a lower-tier CFC, and, as a result of the sale or exchange, a section 245A shareholder with respect to the upper-tier CFC includes an amount in gross income under section 951(a)(1)(A) by reason of section 964(e)(4), then the inclusion is treated as a dividend received directly by the section 245A shareholder from the lower-tier CFC whose earnings and profits give rise to the dividend, and the section 245A shareholder is not allowed a section 245A deduction for the dividend to the extent of the ineligible amount of such dividend.

(3) *Rules regarding stock ownership and stock transfers*—(i) *Determining indirect ownership of stock of an SFC or a CFC.* For purposes of this section, if a person owns an interest in, or stock of, a specified entity, including through a chain of ownership of one or more other specified entities, then the person is considered to own indirectly a pro rata share of stock of an SFC or a CFC owned by the specified entity. To determine a person's pro rata share of stock owned by a specified entity, the principles of section 958(a) apply without regard to whether the specified entity is foreign or domestic.

(ii) *Determining indirect transfers for stock owned indirectly.* If, under paragraph (g)(3)(i) of this section, a person is considered to own indirectly stock of an SFC or CFC that is owned by a specified entity, then the following rules apply in determining if the person transfers stock of the SFC or CFC—

(A) To the extent the specified entity transfers stock that is considered owned indirectly by the person immediately before the transfer, the person is considered to transfer indirectly such stock;

(B) If the person transfers an interest in, or stock of, the specified entity, then the person is considered to transfer indirectly the stock of the SFC or CFC attributable to the interest in, or the stock of, the specified entity that is transferred; and

(C) In the case in which the person owns the specified entity through a chain of ownership of one or more other specified entities, if there is a transfer of an interest in, or stock of, another specified entity in the chain of ownership, then the person is considered to transfer indirectly the stock of the SFC or CFC attributable to the interest in, or the stock of, the other specified entity transferred.

(iii) *Definition of specified entity.* The term *specified entity* means any partnership, trust (other than a trust treated as a corporation for U.S. income tax purposes), or estate (in each case, domestic or foreign), or any foreign corporation.

(4) *Coordination rules*—(i) *General rule.* A dividend is first subject to section 245A(e). To the extent the dividend is not a hybrid dividend or tiered hybrid dividend under section 245A(e), the dividend is subject to paragraph (e) or (f) of this section, as applicable, and then, to the extent the dividend is not subject to paragraph (e) or (f) of this section, it is subject to paragraph (c) or (d) of this section, as applicable.

(ii) *Coordination rule for paragraphs (c) and (d) and (e) and (f) of this section, respectively.* If an SFC or CFC pays a dividend (or simultaneous dividends), a portion of which may be subject to paragraph (c) or (e) of this section and a portion of which may be subject to paragraph (d) or (f) of this section, the rules of this section apply by treating the portion of the dividend or dividends that may be subject to paragraph (c) or (e) of this section as if it occurred immediately before the portion of the dividend or dividends that may be subject to paragraph (d) or (f) of this section. For example, if a dividend arising under section 964(e)(4) occurs at the same time as a dividend that would be eligible for the exception to foreign personal holding company income under section 954(c)(6) but for the potential application of paragraph (d) this section, then the tiered extraordinary disposition amount with respect to the other dividend is determined as if the dividend arising under section 964(e)(4) occurs immediately before the other dividend.

(5) *Ordering rule for multiple dividends made by an SFC or a CFC during a taxable year.* If an SFC or a CFC pays dividends on more than one date during its taxable year or at different times on the same date, this section applies based on the order in which the dividends are paid.

(6) *Partner's distributive share of a domestic partnership's pro rata share of subpart F income or tested income.* If a section 245A shareholder or a U.S. tax resident is a direct or indirect partner in a domestic partnership that is a United States shareholder with respect to a CFC and includes in gross income its distributive share of the domestic partnership's inclusion under section 951(a) or 951A(a) with respect to the CFC then, solely for purposes of this section, a reference to the section 245A shareholder's or U.S. tax resident's pro rata share of the CFC's subpart F income or tested income included in gross income under section 951(a) or 951A(a), respectively, includes such person's distributive share of the domestic partnership's pro rata share of the CFC's subpart F income or tested income. A person is an indirect partner with respect to a domestic partnership if the person indirectly owns the domestic partnership through one or more specified entities (other than a foreign corporation).

(7) *Related domestic corporations treated as a single domestic corporation for certain purposes.* For purposes of determining the extent that a dividend is an extraordinary disposition amount or a tiered extraordinary disposition amount, as well as for purposes of determining the extent to which an extraordinary disposition account is reduced by a prior extraordinary disposition amount, domestic corporations that are related parties are treated as a single domestic corporation. Thus, for example, if two domestic corporations are related parties and either or both of them are section 245A shareholders with respect to an SFC, then the extent to which a dividend received by either domestic corporation from the SFC is an extraordinary disposition amount is based on the sum of each domestic corporation's extraordinary disposition account with respect to the SFC. When, by reason of this paragraph (g)(7), the extent to which a dividend is an extraordinary disposition amount or tiered extraordinary disposition amount is determined based on the sum of two or more extraordinary disposition accounts, a pro rata amount in each extraordinary disposition account is considered to give rise to the extraordinary disposition amount or tiered extraordinary disposition amount, if any.

(h) *Anti-abuse rule.* Appropriate adjustments are made pursuant to this section, including adjustments that would disregard a transaction or arrangement in whole or in part, to any amounts determined under (or subject to the application of) this section if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of this section. For examples illustrating the application of this paragraph (h), see paragraphs (j)(8) through (10) of this section.

(i) *Definitions.* The following definitions apply for purposes of this section.

(1) *Controlled foreign corporation.* The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(2) *Controlling section 245A shareholder.* The term *controlling section 245A shareholder* means, with respect to a CFC, any section 245A shareholder that owns directly or indirectly more than 50 percent (by vote or value) of the stock of the CFC. For purposes of determining whether a section 245A shareholder is a controlling section 245A shareholder with respect to a CFC, all stock of the CFC owned by a related party with respect to the section 245A shareholder or by other persons acting in concert with the section 245A shareholder to undertake an extraordinary reduction is considered owned by the section 245A shareholder. If section 964(e)(4) applies to a sale or exchange of a lower-tier CFC with respect to a controlling section 245A shareholder, all United States shareholders of the CFC are considered to act in concert with regard to the sale or exchange. In addition, if all persons selling stock in a CFC, held directly, sell such stock to the same buyer or buyers (or a related party with respect to the buyer or buyers) as part of the same plan, all sellers will be considered to act in concert with regard to the sale or exchange.

(3) *Disqualified amount.* The term *disqualified amount* has the meaning set forth in paragraph (d)(1) of this section.

(4) *Disqualified period.* The term *disqualified period* has the meaning set forth in paragraph (c)(3)(iii) of this section.

(5) *Extraordinary disposition.* The term *extraordinary disposition* has the meaning set forth in paragraph (c)(3)(ii) of this section.

(6) *Extraordinary disposition account.* The term *extraordinary disposition amount* has the meaning set forth in paragraph (c)(3)(i) of this section.

(7) *Extraordinary disposition amount.* The term *extraordinary disposition amount* has the meaning set forth in paragraph (c)(1) of this section.

(8) *Extraordinary disposition E&P.* The term *extraordinary disposition E&P* has the meaning set forth in paragraph (c)(3)(i)(C) of this section.

(9) *Extraordinary disposition ownership percentage.* The term *extraordinary disposition ownership percentage* has the meaning set forth in paragraph (c)(3)(i)(B) of this section.

(10) *Extraordinary reduction.* The term *extraordinary reduction* has the meaning set forth in paragraph (e)(2)(i)(A) of this section.

(11) *Extraordinary reduction amount.* The term *extraordinary reduction amount* has the meaning set forth in paragraph (e)(1) of this section.

(12) *Ineligible amount.* The term *ineligible amount* has the meaning set forth in paragraph (b)(2) of this section.

(13) *Lower-tier CFC.* The term *lower-tier CFC* means a CFC whose stock is owned (within the meaning of section 958(a)(2)), in whole or in part, by another CFC.

(14) *Non-extraordinary disposition E&P.* The term *non-extraordinary disposition E&P* has the meaning set forth in paragraph (c)(2)(ii) of this section.

(15) *Pre-reduction pro rata share.* The term *pre-reduction pro rata share* has the meaning set forth in paragraph (e)(2)(ii) of this section.

(16) *Prior extraordinary disposition amount.* The term *prior extraordinary disposition amount* has the meaning set forth in paragraph (c)(3)(i)(D) of this section.

(17) *Prior extraordinary reduction amount.* The term *prior extraordinary reduction amount* has the meaning set forth in paragraph (e)(2)(ii)(C) of this section.

(18) *Qualified portion.* The term *qualified portion* has the meaning set forth in paragraph (c)(3)(i)(D)(*2*)(*i*) of this section.

(19) *Related party.* The term *related party* means, with respect to a person, another person bearing a relationship described in section 267(b) or 707(b) to the person, in which case such persons are *related.*

(20) *Section 245A deduction*. The term *section 245A deduction* means, with respect to a dividend received by a section 245A shareholder from an SFC, the amount of the deduction allowed to the section 245A shareholder by reason of the dividend.

(21) *Section 245A shareholder*. The term *section 245A shareholder* means a domestic corporation that is a United States shareholder with respect to an SFC and that owns directly or indirectly stock of the SFC.

(22) *Specified 10-percent owned foreign corporation (SFC)*. The term *specified 10-percent owned foreign corporation* (or *SFC*) has the meaning provided in section 245A(b)(1).

(23) *Specified entity*. The term *specified entity* has the meaning set forth in paragraph (g)(3)(iii) of this section.

(24) *Specified property*. The term *specified property* has the meaning set forth in paragraph (c)(3)(iv) of this section.

(25) *Tiered extraordinary disposition amount*. The term *tiered extraordinary disposition amount* has the meaning set forth in paragraph (d)(2)(i) of this section.

(26) *Tiered extraordinary reduction amount*. The term *tiered extraordinary reduction amount* has the meaning set forth in paragraph (f)(2) of this section.

(27) *United States shareholder*. The term *United States shareholder* has the meaning provided in section 951(b).

(28) *Upper-tier CFC*. The term *upper-tier CFC* means a CFC that owns (within the meaning of section 958(a)(2)) stock in another CFC.

(29) *U.S. tax resident*. The term *U.S. tax resident* means a United States person described in section 7701(a)(30)(A) or (C).

(j) *Examples*. The application of this section is illustrated by the examples in this paragraph (j).

(1) *Facts*. Except as otherwise stated, the facts described in this paragraph (j)(1) are assumed for purposes of the examples.

(i) US1 and US2 are domestic corporations, each with a calendar taxable year, and are not related parties with respect to each other.

(ii) CFC1, CFC2, and CFC3 are foreign corporations that are SFCs and CFCs.

(iii) Each entity uses the U.S. dollar as its functional currency.

(iv) Year 2 begins on or after January 1, 2018 and has 365 days.

(v) Absent application of this section, dividends received by US1 and US2 from a CFC meet the requirements to qualify for the section 245A deduction, and dividends received by one CFC from another CFC qualify for the exception to foreign personal holding company income under section 954(c)(6).

(vi) The de minimis rules in paragraphs (c)(3)(ii)(E) and (e)(3)(ii) of this section do not apply.

(vii) Section 1059 is not relevant to the tax results described in the examples in this paragraph (j).

(2) *Example 1. Extraordinary disposition*—(i) *Facts*. US1 and US2 own 60% and 40%, respectively, of the single class of stock of CFC1. CFC1 owns all of the single class of stock of CFC2. CFC1 and CFC2 use the taxable year ending November 30 as their taxable year. On November 1, 2018, CFC1 sells specified property to CFC2 in exchange for $200x of cash (the ''Property Transfer''). The Property Transfer is outside of CFC1's ordinary course of activities. The transferred property has a basis of $100x in the hands of CFC1. CFC1 recognizes $100x of gain as a result of the Property Transfer ($200x − $100x). On December 1, 2018, CFC1 distributes $80x pro rata to US1 ($48x) and US2 ($32x), all of which is a dividend within the meaning of section 316 and treated as a distribution out of earnings described in section 959(c)(3). No other distributions are made by CFC1 to either US1 or US2 in CFC1's taxable year ending November 30, 2019. For its taxable year ending on November 30, 2019, CFC1 has $110x of earnings and profits described in section 959(c)(3), without regard to any distributions during the taxable year.

(ii) *Analysis*—(A) *Identification of extraordinary disposition*. Because CFC1 is a CFC and uses the taxable year ending on November 30, under paragraph (c)(3)(iii) of this section, it has a disqualified period beginning on January 1, 2018, and ending on November 30, 2018. In addition, under paragraph (c)(3)(ii) of this section, the Property Transfer is an extraordinary disposition because it: Is a disposition of specified property by CFC1 on a date on which it was a CFC and during CFC1's disqualified period; is to CFC2, a related party with respect to CFC1; occurs outside of the ordinary course of CFC1's activities; and, is not subject to the de minimis rule in paragraph (c)(3)(ii)(E) of this section.

(B) *Determination of section 245A shareholders and their extraordinary disposition accounts*. Because CFC1 undertook an extraordinary disposition, under paragraph (c)(3)(i) of this section, a portion of CFC1's earnings and profits are extraordinary disposition E&P and, therefore, give rise to an extraordinary disposition account with respect to each of CFC1's section 245A shareholders. Under paragraph (i)(21) of this section, US1 and US2 are both section 245A shareholders with respect to CFC1. The amount of the extraordinary disposition account with respect to US1 is $60x, which is equal to the product of the extraordinary disposition E&P (the amount of the net gain recognized by CFC1 as a result of the Property Transfer ($100x)) and the extraordinary disposition ownership percentage (the percentage of the stock of CFC1 owned directly or indirectly by US1 on January 1, 2018 (60%)), reduced by the prior extraordinary disposition amount ($0). *See* paragraph (c)(3)(i) of this section. Similarly, the amount of the extraordinary disposition account with respect to US2 is $40x, which is equal to the product of the extraordinary disposition E&P (the net gain recognized by CFC1 as a result of the Property Transfer ($100x)) and extraordinary disposition ownership percentage (the percentage of the stock of CFC1 owned directly or indirectly by US2 on January 1, 2018 (40%)), reduced by the prior extraordinary disposition amount ($0).

(C) *Determination of extraordinary disposition amount with respect to US1.* The dividend of $48x paid to US1 on December 1, 2018, is an extraordinary disposition amount to the extent the dividend is paid out of the extraordinary disposition account with respect to US1. *See* paragraph (c)(1) of this section. Under paragraph (c)(2)(i) of this section, the dividend is first considered paid out of non-extraordinary disposition E&P with respect to US1, to the extent thereof. With respect to US1, $6x of CFC1's earnings and profits is non-extraordinary disposition E&P, calculated as the excess of $66x (the product of $110x of earnings and profits described in section 959(c)(3), without regard to the $80x distribution, and 60%) over $60x (the balance of US1's extraordinary disposition account with respect to CFC1, immediately before the distribution). *See* paragraph (c)(2)(ii) of this section. Thus, $6x of the dividend is considered paid out of non-extraordinary disposition E&P with respect to US1. Under paragraph (c)(2)(i)(B) of this section, the remaining $42x of the dividend is next considered paid out of US1's extraordinary disposition account with respect to CFC1, to the extent thereof. Accordingly, $42x of the dividend is considered paid out of the extraordinary disposition account with respect to CFC1 and gives rise to $42x of an extraordinary disposition amount. As a result, US1's prior extraordinary disposition amount is increased by $42x under paragraph (c)(3)(i)(D) of this section, and US1's extraordinary disposition account is reduced to $18x ($60x − $42x) under paragraph (c)(3)(i)(A) of this section.

(D) *Determination of extraordinary disposition amount with respect to US2.* The dividend of $32x paid to US2, on December 1, 2018, is an extraordinary disposition amount to the extent the dividend is paid out of extraordinary disposition E&P with respect to US2. *See* paragraph (c)(1) of this section. Under paragraph (c)(2)(i) of this section, the dividend is first considered paid out of non-extraordinary disposition E&P with respect to US2, to the extent thereof. With respect to US2, $4x of CFC1's earnings and profits is non-extraordinary disposition E&P, calculated as the excess of $44x (the product of $110x of earnings and profits described in section 959(c)(3), without regard to the $80x distribution, and 40%) over $40x (the balance of US2's extraordinary disposition account with respect to CFC1, immediately before the distribution). *See* paragraph (c)(2)(ii) of this section. Thus, $4x of the dividend is considered paid out of non-extraordinary disposition E&P with respect to US2. Under paragraph (c)(2)(i)(B) of this section, the remaining $28x of the dividend is next considered paid out of US2's extraordinary disposition account with respect to CFC1, to the extent thereof. Accordingly, $28x of the dividend is considered paid out of the extraordinary disposition account with respect to US2 and gives rise to $28x of an extraordinary disposition amount. As a result, US2's prior extraordinary disposition amount is increased by $28x under paragraph (c)(3)(i)(D) of this section, and US2's extraordinary disposition account is reduced to $12x ($40x − $28x) under paragraph (c)(3)(i)(A) of this section.

(E) *Determination of ineligible amount with respect to US1 and US2.* Under paragraph (b)(2) of this section, with respect to US1 and the dividend of $48x, the ineligible amount is $21x, the sum of 50 percent of the extraordinary disposition amount ($42x) and extraordinary reduction amount ($0). Therefore, with respect to the dividend received by US1 of $48x, $27x is eligible for a section 245A deduction. With respect to US2 and the dividend of $32x, the ineligible amount is $14x, the sum of 50% of the extraordinary disposition amount ($28x) and extraordinary reduction amount ($0). Therefore, with respect to the dividend received by US2 of $32x, $18x is eligible for a section 245A deduction.

(3) *Example 2. Application of section 954(c)(6) exception with extraordinary disposition account*—(i) *Facts.* The facts are the same as in paragraph (j)(2)(i) of this section (the facts in *Example 1*) except that the Property Transfer is a sale by CFC2 to CFC1 instead of a sale by CFC1 to CFC2, the $80x distribution is by CFC2 to CFC1 in a separate transaction that is unrelated to the Property Transfer, and the description of the earnings and profits of CFC1 is applied to CFC2. Additionally, absent the application of this section, section 954(c)(6) would apply to the distribution by CFC2 to CFC1. Under section 951(a)(2) and §1.951–1(b) and (e), US1's pro rata share of any subpart F income of CFC1 is 60% and

US2's pro rata share of any subpart F income of CFC2 is 40%.

(ii) *Analysis*—(A) *Identification of extraordinary disposition*. The Property Transfer is an extraordinary disposition under the same analysis as provided in paragraph (j)(2)(ii)(A) of this section (the analysis in *Example 1*).

(B) *Determination of section 245A shareholders and their extraordinary disposition accounts*. Both US1 and US2 are section 245A shareholders with respect to CFC2, US1 has an extraordinary disposition account of $60x with respect to CFC2, and US2 has an extraordinary disposition account of $40x with respect to CFC2 under the same analysis as provided in paragraph (j)(2)(ii)(B) of this section (the analysis in *Example 1*).

(C) *Determination of tiered extraordinary disposition amount*—(*1*) *In general*. US1 and US2 each have a tiered extraordinary disposition amount with respect to the $80x dividend paid by CFC2 to CFC1 to the extent that US1 and US2 would have an extraordinary disposition amount if each had received as a dividend its pro rata share of the dividend from CFC2. *See* paragraph (d)(2)(i) of this section. Under paragraph (d)(2)(ii) of this section, US1's pro rata share of the dividend is $48x (60% × $80x), that is, the increase to US1's pro rata share of the subpart F income if the dividend were included in CFC1's foreign personal holding company income, without regard to section 952(c) and the allocation of expenses. Similarly, US2's pro rata share of the dividend is $32x (40% × $80x).

(*2*) *Determination of tiered extraordinary disposition amount with respect to US1*. The extraordinary disposition amount with respect to US1 is $42x, under the same analysis provided in paragraph (j)(2)(ii)(C) of this section (the analysis in *Example 1*). Accordingly, the tiered extraordinary disposition amount with respect to US1 is $42x.

(*3*) *Determination of extraordinary disposition amount with respect to US2*. The extraordinary disposition amount with respect to US2 is $28x, under the same analysis provided in paragraph (j)(2)(ii)(D) of this section (the analysis in *Example 1*). Accordingly, the tiered extraordinary disposition amount with respect to US2 is $28x.

(D) *Limitation of section 954(c)(6) exception*. The sum of US1 and US2's tiered extraordinary disposition amounts is $70x ($42x + $28x). The portion of the stock of CFC1 (by value) owned (within the meaning of section 958(a)) by U.S. tax residents on the last day of CFC1's taxable year is 100%. Under paragraph (d)(1) of this section, the disqualified amount with respect to the dividend is $70x ($70x/100%). Accordingly, the portion of the $80x dividend from CFC2 to CFC1 that is eligible for the exception to foreign personal holding company income under section 954(c)(6) is $45x, equal to the sum of $10x (the portion of the $80x dividend that exceeds the $70x disqualified amount) and $35x (50 percent of $70x, the portion of the dividend that does not exceed the disqualified amount). Under section 951(a)(2) and §1.951–1(b) and (e), US1 includes $21x (60% × $35x) and US2 includes $14x (40% × $35x) in income under section 951(a).

(E) *Changes in extraordinary disposition account of US1*. Under paragraph (c)(3)(i)(D)(*1*) of this section, US1's prior extraordinary disposition amount with respect to CFC2 is increased by $42x, or 200% of $21x, the amount US1 included in income under section 951(a) with respect to CFC1. Under paragraph (c)(3)(i)(D)(*1*)(*iii*) of this section, US1 has no qualified portion because all of the owners of CFC2 are section 245A shareholders with a tiered extraordinary disposition amount with respect to CFC2. As a result, US1's extraordinary disposition account is reduced to $18x ($60x − $42x) under paragraph (c)(3)(i)(A) of this section.

(F) *Changes in extraordinary disposition account of US2*. Under paragraph (c)(3)(i)(D)(*1*) of this section, US2's prior extraordinary disposition amount with respect to CFC2 is increased by $28x, or 200% of $14x, the amount US2 included in income under section 951(a) with respect to CFC1. Under paragraph (c)(3)(i)(D)(*1*)(*iii*) of this section, US2 has no qualified portion because all of the owners of CFC2 are section 245A shareholders with a tiered extraordinary disposition amount with respect to CFC2. As a result, US2's extraordinary disposition account is reduced to $12x ($40x − $28x) under paragraph (c)(3)(i)(A) of this section.

(4) *Example 3. Extraordinary reduction*—(i) *Facts*. At the beginning of CFC1's taxable year ending on December 31, Year 2, US1 owns all of the single class of stock of CFC1, and no person transferred any CFC1 stock directly or indirectly in Year 1 pursuant to a plan to reduce the percentage of stock (by value) of CFC1 owned by US1. Also as of the beginning of Year 2, CFC1 has no earnings and profits described in section 959(c)(1) or (2), and US1 does not have an extraordinary disposition account with respect to CFC1. As of the end of Year 2, CFC1 has $160x of tested income and no other income. CFC1 has $160x of earnings and profits for Year 2. On October 19, Year 2, US1 sells all of its CFC1 stock to US2 for $100x in a transaction (the ''Stock Sale'') in which US1 recognizes $90x of gain. Under section 1248(a), the entire $90x of gain is included in US1's gross income as a dividend and, pursuant to section 1248(j), the $90x is treated as a dividend for purposes of applying section 245A. At the end of Year 2, under section 951A, US2 takes into account $70x of tested income, calculated as $160x (100% of the $160x of tested income) less $90x, the amount described in section 951(a)(2)(B). The amount described in section 951(a)(2)(B) is the lesser of $90x, the amount of dividends received by US1 with respect to the transferred stock, and $128x, the amount of tested

income attributable to the transferred stock ($160x) multiplied by 292/365 (the ratio of the number of days in Year 2 that US2 did not own the transferred stock to the total number of days in Year 2). US1 does not make an election pursuant to paragraph (e)(3)(i) of this section.

(ii) *Analysis*—(A) *Determination of controlling section 245A shareholder and extraordinary reduction of ownership.* Under paragraph (i)(2) of this section, US1 is a controlling section 245A shareholder with respect to CFC1. In addition, the Stock Sale results in an extraordinary reduction with respect to US1's ownership of CFC1. *See* paragraph (e)(2)(i) of this section. The extraordinary reduction occurs because during Year 2, US1 transferred 100% of the CFC1 stock it owned at the beginning of the year and such amount is more than 5% of the total value of the stock of CFC1 at the beginning of Year 2; it also occurs because on the last day of the year the percentage of stock (by value) of CFC1 that US1 owns directly or indirectly (0%) (the end of year percentage) is less than 90% of the stock (by value) of CFC1 that US1 owns directly or indirectly on the day of the taxable year when it owned the highest percentage of CFC1 stock by value (100%) (the initial percentage), no transactions occurred in the preceding year pursuant to a plan to reduce the percentage of CFC1 stock owned by US1, and the difference between the initial percentage and the end of year percentage (100 percentage points) is at least 5 percentage points.

(B) *Determination of extraordinary reduction amount.* Under paragraph (e)(1) of this section, the entire $90x dividend to US1 is an extraordinary reduction amount with respect to US1 because the dividend is at least equal to US1's pre-reduction pro rata share of CFC1's Year 2 tested income described in paragraph (e)(2)(ii)(A) of this section ($160x), reduced by the amount of tested income taken into account by US2, a U.S. tax resident, under paragraph (e)(2)(ii)(B) of this section ($70x).

(C) *Determination of ineligible amount.* Under paragraph (b)(2) of this section, with respect to US1 and the dividend of $90x, the ineligible amount is $90x, the sum of 50% of the extraordinary disposition amount ($0) and extraordinary reduction amount ($90x). Therefore, with respect to the dividend received of $90x, no portion is eligible for the dividends received deduction allowed under section 245A(a).

(iii) *Alternative facts—election to close CFC's taxable year.* The facts are the same as in paragraph (j)(4)(i) of this section (the facts of this *Example 3*), except that, pursuant to paragraph (e)(3)(i) of this section, US1 elects to close CFC1's Year 2 taxable year for all purposes of the Code as of the end of October 19, Year 2, the date on which the Stock Sale occurs; in addition, US1 and US2 enter into a written, binding agreement that US1 will elect to close CFC1's Year 2 taxable year. Accordingly, under section 951A(a), US1 takes into account 100% of CFC1's tested income for the taxable year beginning January 1, Year 2, and ending October 19, Year 2, and US2 takes into account 100% of CFC1's tested income for the taxable year beginning October 20, Year 2, and ending December 31, Year 2. Under paragraph (e)(3)(i)(A) of this section, no amount is considered an extraordinary reduction amount with respect to US1.

(5) *Example 4. Extraordinary reduction; decrease in section 245A shareholder's pre-reduction pro rata share for amounts taken into account by U.S. tax residents*—(i) *Facts.* At the beginning of CFC1's taxable year ending December 31, Year 2, US1 owns all of the single class of stock of CFC1, and no person transferred any CFC1 stock directly or indirectly in Year 1 pursuant to a plan to reduce the percentage of stock (by value) of CFC1 owned by US1. CFC1 generates $120x of subpart F income during its taxable year ending on December 31, Year 2. On October 1, Year 2, CFC1 distributes a $120x dividend to US1. On October 19, Year 2, US1 sells 100% of its stock of CFC1 to PRS, a domestic partnership, in a transaction in which no gain or loss is realized (the "Stock Sale"). A, an individual who is a citizen of the United States, and B, a foreign individual who is not a U.S. tax resident, each own 50% of the capital and profits interests of PRS. On December 1, Year 2, US2 and FP, a foreign corporation, contribute property to CFC1; in exchange, each of US2 and FP receives 25% of the stock of CFC1. PRS owns the remaining 50% of the stock of CFC1. US1 does not make an election pursuant to paragraph (e)(3)(i) of this section.

(ii) *Analysis*—(A) *Determination of controlling section 245A shareholder and extraordinary reduction.* Under paragraph (i)(2) of this section, US1 is a controlling section 245A shareholder with respect to CFC1. In addition, the Stock Sale results in an extraordinary reduction with respect to US1's ownership of CFC1. *See* paragraph (e)(2)(i) of this section. The extraordinary reduction occurs because during Year 2, US1 transferred 100% of the CFC1 stock it owns on the first day of Year 2, and that amount is more than 5% of the total value of the stock of CFC1 at the beginning of Year 2; it also occurs because on the last day of Year 2 the percentage of stock (by value) of CFC1 that US1 owns directly or indirectly (0%) (the end of year percentage) is less than 90% of the highest percentage of stock (by value) of CFC1 that US1 owns directly or indirectly on the day of the taxable year when it owned the highest percentage of CFC1 stock by value (100%) (the initial percentage), no transactions occurred in the preceding year pursuant to a plan to reduce the percentage of CFC1 stock owned by US1, and the difference between the initial percentage and the end of year percentage (100 percentage points) is at least 5 percentage points.

(B) *Determination of pre-reduction pro rata share.* Before the extraordinary reduction, US1 owned 100% of the stock of CFC1. Thus, under paragraph (e)(2)(ii)(A) of this section, the tentative amount of US1's pre-reduction pro rata share of CFC1's subpart F income is $120x. A and US2 are U.S. tax residents pursuant to paragraph (i)(29) of this section because they are United States persons described in section 7701(a)(30)(A) or (C). Thus, US1's pre-reduction pro rata share amount is subject to the reduction described in paragraph (e)(2)(ii)(B) of this section because U.S. tax residents directly or indirectly acquire stock of CFC1 from US1 or CFC1 during the taxable year in which the extraordinary reduction occurs. With respect to US1's pre-reduction pro rata share of CFC1's subpart F income, the reduction equals the amount of subpart F income of CFC1 taken into account under section 951(a) by these U.S. tax residents.

(C) *Determination of decrease in pre-reduction pro rata share for amounts taken into account by U.S. tax resident.* On December 31, Year 2, both PRS and US2 will be United States shareholders with respect to CFC1 and will include in gross income their pro rata share of CFC1's subpart F income under section 951(a). With respect to US2, this amount will be $30x, which is equal to 25% of CFC1's subpart F income for the taxable year. With respect to PRS, its pro rata share of $60x under section 951(a)(2)(A) (50% of $120x) will be reduced under section 951(a)(2)(B) by $48x. The section 951(a)(2)(B) reduction is equal to the lesser of the $120x dividend paid with respect to those shares to US1 or $48x (50% × $120x × 292/365, the period during the taxable year that PRS did not own CFC1 stock). Thus, PRS includes $12x in gross income pursuant to section 951(a). Of this amount, $6x is allocated to A (as a 50% partner of PRS) and, therefore, treated as taken into account by A under paragraphs (e)(2)(ii)(B) and (g)(6) of this section. Thus, A and US2 take into account a total of $36x of CFC1's subpart F income under section 951(a). This amount reduces US1's pre-reduction pro rata share of CFC1's subpart F income to $84x ($120x − $36x) under paragraph (e)(2)(ii)(B) of this section. CFC1 did not generate tested income during the taxable year and, therefore, no amount is taken into account under section 951A with respect to CFC1, and US1 has no pre-reduction pro rata share with respect to tested income of CFC1.

(D) *Determination of extraordinary reduction amount.* Under paragraph (e)(1) of this section, the extraordinary reduction amount equals $84x, which is the lesser of the amount of the dividend received by US1 from CFC1 during Year 2 ($120x) and the sum of US1's pre-reduction pro rata share of CFC1's subpart F income ($84x) and tested income ($0).

(E) *Determination of ineligible amount.* Under paragraph (b)(2) of this section, with respect to US1 and the dividend of $120x, the ineligible amount is $84x, the sum of 50% of the extraordinary disposition amount ($0) and extraordinary reduction amount ($84x). Therefore, with respect to the dividend received by US1 from CFC1, $36x ($120x − $84x) is eligible for a section 245A deduction.

(6) *Example 5. Controlling section 245A shareholder*—(i) *Facts.* US1 and US2 own 30% and 25% of the stock of CFC1, respectively. FP, a foreign corporation that is not a CFC, owns all of the stock of US1 and US2. FP owns the remaining 45% of the stock of CFC1. On September 30, Year 2, US1 sells all of its stock of CFC1 to US3, a domestic corporation that is not a related party with respect to FP, US1, or US2. No person transferred any stock of CFC1 directly or indirectly in Year 1 pursuant to a plan to reduce the percentage of stock (by value) of CFC1 owned by US1.

(ii) *Analysis.* Under paragraph (i)(21) of this section, US1 is a section 245A shareholder with respect to CFC1, an SFC. Because US1 owns, together with US2 and FP (related persons with respect to US1), more than 50% of the stock of CFC1, US1 is a controlling section 245A shareholder of CFC1. The sale of US1's CFC1 stock results in an extraordinary reduction occurring with respect to US1's ownership of CFC1. The extraordinary reduction occurs because during Year 2, US1 transferred 100% of the stock of CFC1 that it owned at the beginning of the year and that amount is more than 5% of the total value of the stock of CFC1 at the beginning of Year 2. The extraordinary disposition also occurs because on the last day of the year the percentage of stock (by value) of CFC1 that US1 directly or indirectly owns (0%) (the end of year percentage) is less than 90% of the stock (by value) of CFC1 that US1 directly or indirectly owned on the day of the taxable year when it owned the highest percentage of CFC1 stock by value (30%) (the initial percentage), no transactions occurred in the preceding year pursuant to a plan to reduce the percentage of CFC1 stock owned by US1, and the difference between the initial percentage and end of year percentage (30 percentage points) is at least 5 percentage points.

(7) *Example 6. Limitation of section 954(c)(6) exception with respect to an extraordinary reduction*—(i) *Facts.* At the beginning of CFC1 and CFC2's taxable year ending on December 31, Year 2, US1 and A, an individual who is a citizen of the United States, own 80% and 20% of the single class of stock of CFC1, respectively. CFC1 owns 100% of the stock of CFC2. Both US1 and A are United States shareholders with respect to CFC1 and CFC2, and US1 and A are not related parties with respect to each other. No person transferred

CFC2 stock directly or indirectly in Year 2 pursuant to a plan to reduce the percentage of stock (by value) of CFC2 owned by US1, and US1 does not have an extraordinary disposition account with respect to CFC2. At the end of Year 2, and without regard to any distributions during Year 2, CFC2 had $150x of tested income and no other income, and CFC1 had no income or expenses. On June 30, Year 2, CFC2 distributed $150x as a dividend to CFC1, which would qualify for the exception from foreign personal holding company income under section 954(c)(6) but for the application of this section. On August 7, Year 2, CFC1 sells all of its CFC2 stock to US2 for $100x in a transaction (the ''Stock Sale'') in which CFC1 realizes no gain or loss. At the end of Year 2, under section 951A, US2 takes into account $60x of tested income, calculated as $150x (100% of the $150x of tested income) less $90x, the amount described in section 951(a)(2)(B). The amount described in section 951(a)(2)(B) is the lesser of $150x, the amount of dividends received by CFC1 during Year 2 with respect to the transferred stock, and $90x, the amount of tested income attributable to the transferred stock ($150x) multiplied by 219/365 (the ratio of the number of days in Year 2 that US2 did not own the transferred stock to the total number of days in Year 2). US1 does not make an election pursuant to paragraph (e)(3)(i) of this section.

(ii) *Analysis*—(A) *Determination of controlling section 245A shareholder and extraordinary reduction of ownership.* Under paragraph (i)(2) of this section, US1 is a controlling section 245A shareholder with respect to CFC2, but A is not. In addition, the Stock Sale results in an extraordinary reduction with respect to US1's ownership of CFC2. *See* paragraph (e)(2)(i) of this section. The extraordinary reduction occurs because during Year 2, US1 transferred indirectly 100% of the CFC2 stock it owned at the beginning of the year and such amount is more than 5% of the total value of the stock of CFC2 at the beginning of Year 2. The extraordinary disposition also occurs because on the last day of the year the percentage of stock (by value) of CFC2 that US1 owns directly or indirectly (0%) (the end of year percentage) is less than 90% of the stock (by value) of CFC2 that US1 owns directly or indirectly on the day of the taxable year when it owned the highest percentage of CFC2 stock by value (80%) (the initial percentage), no transactions occurred in the preceding year pursuant to a plan to reduce the percentage of CFC2 stock owned by US1, and the difference between the initial percentage and the end of year percentage (80 percentage points) is at least 5 percentage points. Because there is an extraordinary reduction with respect to CFC2 in Year 2 and CFC1 received a dividend from CFC2 in Year 2, under paragraph (f)(1) of this section, it is necessary to determine the limitation on the amount of the dividend eligible for the exception under section 954(c)(6).

(B) *Determination of tiered extraordinary reduction amount.* The limitation on the amount of the dividend eligible for the exception under section 954(c)(6) is based on the tiered extraordinary reduction amount. The sum of the amount of subpart F income and tested income of CFC2 for Year 2 is $150x, and immediately before the extraordinary reduction, CFC1 held 100% of the stock of CFC2. Additionally, US2 is a U.S. tax resident as defined in paragraph (i)(29) of this section because it is a United States person described in section 7701(a)(30)(A) or (C), and US2 has a pro rata share of $60x of tested income under section 951A with respect to CFC2. Accordingly, under paragraph (f)(2) of this section, the tiered extraordinary reduction amount is $90x (($150x × 100%) − $60x).

(C) *Limitation of section 954(c)(6) exception.* Under paragraph (f)(1) of this section, the portion of the $150x dividend from CFC2 to CFC1 that is eligible for the exception to foreign personal holding company income under section 954(c)(6) is $60x ($150x − $90x). To the extent that the $90x that does not qualify for the exception gives rise to additional subpart F income to CFC1, both US1 and A will take into account their pro rata share of that subpart F income under section 951(a)(2) and §1.951–1(b) and (e).

(8) *Example 7. Application of anti-abuse rule to a prepayment of a royalty*—(i) *Facts.* US1 owns 100% of the single class of stock of CFC1 and CFC2. CFC1 has a November 30 taxable year, and CFC2 has a calendar year taxable year. There is a license agreement between CFC1 and CFC2 pursuant to which CFC2 is obligated to pay annual royalties to CFC1 for the use of intangible property. As of November 1, 2018, the remaining term of the agreement is 10 years. On November 1, 2018, CFC1 receives from CFC2, and accrues into income, $100x of pre-paid royalties that are for the use of the intangible property for the subsequent 10 years. The form of the arrangement as a license, including the prepayment of the royalty, is respected for U.S. tax purposes; therefore CFC1's receipt of the $100x royalty prepayment does not constitute a disposition of the intangible property and is excluded from CFC1's subpart F income pursuant to section 954(c)(6). A principal purpose of CFC2 prepaying the royalty is for CFC1 to generate earnings and profits during the disqualified period that would not be subject to current U.S. tax yet may be eligible for the section 245A deduction and could, for example, be used to reduce the amount of gain recognized on a disposition of the stock of CFC1 that would be subject to U.S. tax by increasing the portion of such gain treated as a dividend.

(ii) *Analysis.* Because the royalty prepayment was carried out with a principal purpose of avoiding the purposes of this section, appropriate adjustments are required to be made under the anti-abuse rule in paragraph (h) of this section. CFC1 is a CFC that has a November 30 taxable year, so under paragraph (c)(3)(iii) of this section, CFC1 has a disqualified period beginning on January 1, 2018, and ending on November 30, 2018. In addition, even though the intangible property licensed by CFC1 to CFC2 is specified property, CFC2's prepayment of the royalty would not be treated as a disposition of the specified property by CFC1 and, therefore, would not constitute an extraordinary disposition (and thus would not give rise to extraordinary disposition E&P), absent the application of the anti-abuse rule of paragraph (h) of this section. Pursuant to paragraph (h) of this section, the earnings and profits of CFC1 generated as a result of the $100x of prepaid royalty are treated as extraordinary disposition E&P for purposes of this section and, therefore, US1 has an extraordinary disposition account with respect to CFC1 of $100x. In addition, the prepaid royalty gives rise to a disqualified payment (as defined in §1.951A–2(c)(6)(ii)(A)) of $100x. As a result, §1.245A–7(b) or §1.245A–8(b), as applicable, applies to reduce the disqualified payment in the same manner as if the disqualified payment were disqualified basis, and §1.245A–7(c) or §1.245A–8(c), as applicable, applies to reduce the extraordinary disposition account in the same manner as if the deductions directly or indirectly related to the disqualified payment were deductions attributable to disqualified basis of an item of specified property that corresponds to the extraordinary disposition account.

(9) *Example 8. Application of anti-abuse rule to restructuring transaction*—(i) *Facts.* FP, a foreign corporation with no United States shareholders, owns 100% of the single class of stock of US1. US1 owns 100% of the single class of stock of CFC1 that, in turn, owns 100% of the single class of stock of CFC2. CFC2 has $100x of extraordinary disposition E&P, and US1 has a $100x extraordinary disposition account with respect to CFC2. In Year 1, FP transfers property to CFC1 in exchange for newly issued stock of CFC1. After the transfer, FP and US1 own, respectively, 90% and 10% of the single class of stock of CFC1. In Year 3, CFC2 pays a $100x dividend to CFC1, and the dividend gives rise to a tiered extraordinary disposition amount with respect to US1 of $10x. US1 includes $10x in gross income under section 951(a) with respect to the tiered extraordinary disposition amount. The $10x tiered extraordinary disposition amount reduces US1's extraordinary disposition account from $100x to $90x. In Year 5, CFC1 redeems all of the stock of CFC1 held by US1 in exchange for $100x of cash. Under sections 302(d) and 301(c)(1), the redemption results in a $100x dividend to US1. Under section 959(a), $10x of the $100x dividend is not included in US1's gross income and, but for the application of paragraph (h) of this section, US1 would claim a section 245A deduction of $90x with respect to $90x of the dividend. The transfer of property from FP to CFC1 in exchange for stock of CFC1, the $100x dividend from CFC2 to CFC1, and CFC1's redemption of all of its stock held by US1 (together, the ''Transaction'') were undertaken with the principal purpose of avoiding the application of this section to distributions from CFC2. As a result of the redemption, CFC2 is wholly owned by FP through CFC1, and CFC2's earnings and profits can be distributed without incurring U.S. tax irrespective of the availability of the section 245A deduction or the exception under section 954(c)(6).

(ii) *Analysis.* Because the Transaction was carried out with a principal purpose of avoiding the purposes of this section, appropriate adjustments are required to be made under the anti-abuse rule in paragraph (h) of this section. Pursuant to paragraph (h) of this section, all $90x of the dividend included in US1's income in Year 5 is treated as an extraordinary disposition amount. Therefore, $45x of the dividend is treated as an ineligible amount for which US1 cannot claim a section 245A deduction pursuant to paragraph (b)(2)(i) of this section (that is, 50% of the extraordinary disposition amount) and, accordingly, US1 is only allowed a section 245A deduction of $45x ($90x dividend received, less the $45x ineligible amount) with respect to the $90x dividend from CFC1 that it included in income. In addition, US1's extraordinary disposition account with respect to CFC2 is reduced from $90x to zero pursuant to paragraph (c)(3)(i)(A) and (D) of this section.

(10) *Example 9. Application of anti-abuse rule to a related-party loan*—(i) *Facts.* US1 owns 100% of the single class of stock of CFC1 and CFC2. US1 does not own stock of any other foreign corporation. US1 intends to repatriate $100x cash from CFC1 at the end of taxable year Y1. At the end of taxable year Y1, CFC1 has $100x of earnings and profits described in section 959(c)(3) (all of which is extraordinary disposition E&P) and $100x of cash, and US1 has an extraordinary disposition account balance with respect to CFC1 equal to $100x. In addition, at the end of taxable year Y1, CFC2 has $100x of earnings and profits described in section 959(c)(3). US1 does not have an extraordinary disposition account with respect to CFC2. Anticipating the application of this section to a distribution from CFC1, US1 instead causes CFC1 to loan $100x of cash to CFC2 during taxable year Y1 in exchange for a $100x note. The form of the transaction is respected as a loan for U.S. tax purposes. At the end of taxable Y1, CFC2 distributes $100x of cash to US1. The loan and distribution are part of a plan a principal purpose of which is to repatriate

CFC1's $100x cash without triggering the application of this section.

(ii) *Analysis.* Because the loan from CFC1 to CFC2 and the subsequent distribution of cash were carried out with a principal purpose of avoiding the purposes of this section, appropriate adjustments are required to be made under the anti-abuse rule in paragraph (h) of this section. Pursuant to that rule, the distribution of $100x of cash is treated as a distribution out of US1's extraordinary disposition account with respect to CFC1. Accordingly, the $100x distribution is taxed as a dividend, and only $50x of the dividend received by US1 is eligible for the section 245A deduction pursuant to paragraph (b)(1) of this section. As a result of the distribution, the balance of US1's extraordinary disposition account with respect to CFC1 is reduced by $100x to zero pursuant to paragraph (c)(3)(i)(A) of this section.

(k) *Applicability date*—(1) *In general.* This section applies to taxable periods of a foreign corporation ending on or after June 14, 2019, and to taxable periods of section 245A shareholders in which or with which such taxable periods end. For taxable periods described in the previous sentence, this section (and not §1.245A–5T) applies regardless of whether, but for this paragraph (k)(1), §1.245A–5T would apply. See §1.245A–5T as contained in 26 CFR part 1 edition revised as of April 1, 2020 for distributions occurring after December 31, 2017, as to which this section does not apply.

(2) *Early application of this section.* Notwithstanding paragraph (k)(1) of this section, a taxpayer may choose to apply this section to taxable periods of a foreign corporation ending before June 14, 2019, and to taxable periods of section 245A shareholders in which or with which such taxable periods end, provided that the taxpayer and all persons bearing a relationship to the taxpayer described in section 267(b) or 707(b) apply this section in its entirety for all such taxable periods.

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§ 1.245A–6 Coordination of extraordinary disposition and disqualified basis rules.

(a) *Scope.* This section and §§1.245A–7 through 1.245A–11 coordinate the application of the extraordinary disposition rules of §1.245A–5(c) and (d) and the disqualified basis rule of §1.951A–2(c)(5). Section 1.245A–7 provides coordination rules for simple cases, and §1.245A–8 provides coordination rules for complex cases. Section 1.245A–9 provides definitions and other rules, including rules of general applicability for purposes of this section and §§1.245A–7 through 1.245A–11. Section 1.245A–10 provides examples illustrating the application of this section and §§1.245A–7 through 1.245A–9. Section 1.245A–11 provides applicability dates.

(b) *Conditions to apply coordination rules for simple cases.* For a taxable year of a section 245A shareholder for which the conditions described in paragraphs (b)(1) and (2) of this section are satisfied, the section 245A shareholder may apply the coordination rules of §1.245A–7 (rules for simple cases) to an extraordinary disposition account of the section 245A shareholder with respect to an SFC and disqualified basis of an item of specified property that corresponds to the extraordinary disposition account (as determined pursuant to §1.245A–9(b)(1)). If the conditions are not satisfied, then the coordination rules of §1.245A–8 (rules for complex cases) apply beginning with the first day of the first taxable year of the section 245A shareholder for which the conditions are not satisfied and all taxable years thereafter. If the conditions are satisfied for a taxable year of the section 245A shareholder but the section 245A shareholder chooses not to apply the coordination rules of §1.245A–7 for that taxable year, then the coordination rules of §1.245A–8 apply to that taxable year (though, for a subsequent taxable year, the section 245A shareholder may apply the coordination rules of §1.245A–7, provided that the conditions described in paragraphs (b)(1) and (2) of this section are satisfied for such subsequent taxable year and have been satisfied for all earlier taxable years). For purposes of applying paragraphs (b)(1) and (2) of this section, a reference to a section 245A shareholder, an SFC, or a CFC does not include a successor of the section 245A shareholder, the SFC, or the CFC, respectively.

(1) *Requirements related to the SFC.* The condition of this paragraph (b)(1)

is satisfied for a taxable year of the section 245A shareholder if the following requirements are satisfied:

(i) On January 1, 2018, the section 245A shareholder owns (within the meaning of section 958(a)) all of the stock (by vote and value) of the SFC.

(ii) On each day of the taxable year of the section 245A shareholder, the section 245A shareholder owns (within the meaning of section 958(a)) all of the stock (by vote and value) of the SFC.

(iii) On no day during the taxable year of the section 245A shareholder was the SFC a distributing or controlled corporation in a transaction described in a section 355, or did the SFC acquire the assets of a corporation as to which there is an extraordinary disposition account pursuant to a transaction described in section 381 (that is, taking into account the requirements of this paragraph (b)(1) and paragraph (b)(2) of this section, the section 245A shareholder's extraordinary disposition account with respect to the SFC has not been not been adjusted pursuant to the rules of §1.245A–5(c)(4)).

(2) *Requirements related to an item of specified property that corresponds to an extraordinary disposition account and a CFC holding the item.* The condition of this paragraph (b)(2) is satisfied for a taxable year of a section 245A shareholder if the following requirements are satisfied:

(i) For each item of specified property with disqualified basis that corresponds to the extraordinary disposition account, the item of specified property is held by a CFC immediately after the extraordinary disposition of the item of specified property.

(ii) For each CFC described in paragraph (b)(2)(i) of this section—

(A) All of the stock (by vote and value) of the CFC is owned (within the meaning of section 958(a)) by the section 245A shareholder and any domestic affiliates of the section 245A shareholder immediately after the extraordinary disposition described in paragraph (b)(2)(i) of this section;

(B) For each taxable year of the CFC that ends with or within the taxable year of the section 245A shareholder, there is no extraordinary disposition account with respect to the CFC, and the sum of the balance of the hybrid deduction accounts (as described in §1.245A(e)–1(d)(1)) with respect to shares of stock of the CFC is zero (determined as of the end of the taxable year of the CFC and taking into account any adjustments to the accounts for the taxable year); and

(C) On each day of each taxable year of the CFC that ends with or within the taxable year of the section 245A shareholder, and on each day of each taxable year of the CFC that begins with or within the taxable year of the section 245A shareholder—

(*1*) The CFC holds the item of specified property described in paragraph (b)(1)(i) of this section;

(*2*) The section 245A shareholder and any domestic affiliates own (within the meaning of section 958(a)) all of the stock (by vote and value) of the CFC;

(*3*) The CFC does not hold any item of specified property with disqualified basis other than an item of specified property that corresponds to the extraordinary disposition account;

(*4*) The CFC does not own an interest in a partnership, trust, or estate (directly or indirectly through one or more other partnerships, trusts, or estates) that holds an item of specified property with disqualified basis; and

(*5*) The CFC is not engaged in the conduct of a trade or business in the United States and therefore does not have ECTI, and the CFC does not have any deficit in earnings and profits subject to §1.381(c)(2)–1(a)(5).

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A–7 Coordination rules for simple cases.

(a) *Scope.* This section applies for a taxable year of a section 245A shareholder for which the conditions of §1.245A–6(b)(1) and (2) are satisfied and for which the section 245A shareholder chooses to apply this section (in lieu of §1.245A–8).

(b) *Reduction of disqualified basis by reason of an extraordinary disposition amount or tiered extraordinary disposition amount*—(1) *In general.* If, for a taxable year of a section 245A shareholder, an extraordinary disposition account of the section 245A shareholder gives rise to one or more extraordinary disposition amounts or tiered extraordinary disposition amounts, then, with respect to an item of specified property that corresponds to the extraordinary disposition account, the disqualified basis of the item of specified property is, solely for purposes of §1.951A–2(c)(5), reduced (but not below zero) by an amount (determined in the functional currency in which the extraordinary disposition account is maintained) equal to the product of—

(i) The sum of the extraordinary disposition amounts and the tiered extraordinary disposition amounts; and

(ii) A fraction, the numerator of which is the disqualified basis of the item of specified property, and the denominator of which is the sum of the disqualified basis of each item of specified property that corresponds to the extraordinary disposition account.

(2) *Timing rules regarding disqualified basis.* See §1.245A–9(b)(2) for timing rules regarding the determination of, and reduction to, disqualified basis of an item of specified property.

(3) *Special rule regarding prior extraordinary disposition amounts.* For purposes of paragraph (b)(1) of this section, to the extent that an extraordinary disposition account of a section 245A shareholder is reduced under §1.245A–5(c)(3)(i)(A) by reason of a prior extraordinary disposition amount described in §1.245A–5(c)(3)(i)(D)(*1*)(*i*) through (*iv*), the extraordinary disposition account is considered to give rise to an extraordinary disposition amount or tiered extraordinary disposition amount (and the amount by which the account is reduced is treated as an extraordinary disposition amount or tiered extraordinary disposition amount).

(c) *Reduction of extraordinary disposition account by reason of the allocation and apportionment of deductions or losses attributable to disqualified basis*—(1) *In general.* If, for a taxable year of a CFC, the CFC holds one or more items of specified property that correspond to an extraordinary disposition account of a section 245A shareholder with respect to an SFC, then the extraordinary disposition account is reduced (but not below zero) by the lesser of the amounts described in paragraphs (c)(1)(i) and (ii) of this section (each determined in the functional currency of the CFC).

(i) The excess (if any) of the adjusted earnings of the CFC for the taxable year of the CFC, over the sum of the previously taxed earnings and profits accounts with respect to the CFC for purposes of section 959 (determined as of the end of the taxable year of the CFC and taking into account any adjustments to the accounts for the taxable year).

(ii) The balance of the section 245A shareholder's RGI account with respect to the CFC (determined as of the end of the taxable year of the CFC, but without regard to the application of paragraph (c)(4)(ii) of this section for the taxable year).

(2) *Timing of reduction to extraordinary disposition account.* See §1.245A–9(b)(3) for timing rules regarding the reduction to an extraordinary disposition account.

(3) *Adjusted earnings.* The term *adjusted earnings* means, with respect to a CFC and a taxable year of the CFC, the earnings and profits of the CFC, determined as of the end of the CFC's taxable year (taking into account all distributions during the taxable year), and with the adjustments described in paragraphs (c)(3)(i) through (iii) of this section.

(i) The earnings and profits are increased by the amount of any deduction or loss that is or was allocated and apportioned to residual CFC gross income of the CFC solely by reason of §1.951A–2(c)(5)(i).

(ii) The earnings and profits are decreased by the amount by which an RGI account with respect to the CFC has been decreased pursuant to paragraph (c)(4)(ii) of this section for a prior taxable year of the CFC.

(iii) The earnings and profits are determined without regard to income described in section 245(a)(5)(A) or dividends described in section 245(a)(5)(B) (determined without regard to section 245(a)(12)).

(4) *RGI account.* For a taxable year of a CFC, the following rules apply to determine the balance of a section 245A shareholder's RGI account with respect to the CFC:

(i) The balance of the RGI account is increased by the sum of the amounts of deductions and losses of the CFC that, but for §1.951A–2(c)(5)(i), would have decreased one or more categories of the CFC's positive subpart F income or the CFC's tested income, or increased or given rise to a tested loss or one or more qualified deficits of the CFC.

(ii) The balance of the RGI account is decreased to the extent that, by reason of the application of paragraph (c)(1) of this section with respect to the taxable year of the CFC, there is a reduction to the extraordinary disposition account of the section 245A shareholder.

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A–8 Coordination rules for complex cases.

(a) *Scope*. This section applies beginning with the first day of the first taxable year of a section 245A shareholder for which § 1.245A–7 does not apply and for all taxable years thereafter, or for a taxable year of a section 245A shareholder for which the section 245A shareholder chooses not to apply § 1.245A–7.

(b) *Reduction of disqualified basis by reason of an extraordinary disposition amount or tiered extraordinary disposition amount*—(1) *In general*. If, for a taxable year of a section 245A shareholder, an extraordinary disposition account of the section 245A shareholder gives rise to one or more extraordinary disposition amounts or tiered extraordinary disposition amounts, then, with respect to an item of specified property that corresponds to the extraordinary disposition account and for which the ownership requirement of paragraph (b)(3)(i) of this section is satisfied for the taxable year of the section 245A shareholder, solely for purposes of § 1.951A–2(c)(5), the disqualified basis of the item of specified property is reduced (but not below zero) by an amount (determined in the functional currency in which the extraordinary disposition account is maintained) equal to the product of—

(i) The excess (if any) of—

(A) The sum of the extraordinary disposition amounts and the tiered extraordinary disposition amounts; over

(B) The basis benefit account with respect to the extraordinary disposition account (determined as of the end of the taxable year of the section 245A shareholder, and without regard to the application of paragraph (b)(4)(i)(B) of this section for the taxable year); and

(ii) A fraction, the numerator of which is the disqualified basis of the item of specified property, and the denominator of which is the sum of the disqualified basis of each item of specified property that corresponds to the extraordinary disposition account and for which the ownership requirement of paragraph (b)(3)(i) of this section is satisfied for the taxable year of the section 245A shareholder.

(2) *Timing rules regarding disqualified basis*. See § 1.245A–9(b)(2) for timing rules regarding the determination of, and reduction to, disqualified basis of an item of specified property.

(3) *Ownership requirement with respect to an item of specified property*—(i) *In general*. For a taxable year of a section 245A shareholder, the ownership requirement of this paragraph (b)(3)(i) is satisfied with respect to an item of specified property if, on at least one day that falls within the taxable year, the item of specified property is held by—

(A) The section 245A shareholder;

(B) A person (other than the section 245A shareholder) that, on at least one day that falls within the section 245A shareholder's taxable year, is a related party with respect to the section 245A shareholder (such a person, a *qualified related party* with respect to the section 245A shareholder for the taxable year of the section 245A shareholder); or

(C) A specified entity at least 10 percent of the interests of which are, on at least one day that falls within the section 245A shareholder's taxable year, owned directly or indirectly through one or more other specified entities by the section 245A shareholder or a qualified related party.

(ii) *Rules for determining an interest in a specified entity*. For purposes of paragraph (b)(3)(i)(C) of this section, the phrase *at least 10 percent of the interests* means—

(A) If the specified entity is a foreign corporation, at least 10 percent of the stock (by vote or value) of the foreign corporation;

(B) If the specified entity is a partnership, at least 10 percent of the interests in the capital or profits of the partnership; or

(C) If the specified entity is not a foreign corporation or a partnership, at least 10 percent of the value of the interests in the specified entity.

(4) *Basis benefit account*—(i) *General rules*. The term *basis benefit account* means, with respect to an extraordinary disposition account of a section 245A shareholder, an account of the section 245A shareholder (the initial balance of which is zero), adjusted pursuant to the rules of paragraphs (b)(4)(i)(A) and (B) of this section on the last day of each taxable year of the section 245A shareholder. The basis benefit account must be maintained in the same functional currency as the extraordinary disposition account.

(A) The balance of the basis benefit account is increased to the extent that a basis benefit amount with respect to an item of specified property that corresponds to the section 245A shareholder's extraordinary disposition account is assigned to the taxable year of the section 245A shareholder. However, if the extraordinary disposition ownership percentage applicable to the section 245A shareholder's extraordinary disposition account is less than 100 percent, then, the basis benefit account is instead increased by the amount equal to the basis benefit amount multiplied by the extraordinary disposition ownership percentage.

(B) The balance of the basis benefit account is decreased to the extent that, for a taxable year that includes the date on which the section 245A shareholder's taxable year ends, disqualified basis of an item of specified property would have been reduced pursuant to paragraph (b)(1) of this section but for an amount in the basis benefit account.

(ii) *Rules for determining a basis benefit amount*—(A) *In general*. The term *basis benefit amount* means, with respect to an item of specified property that has disqualified basis, the portion of disqualified basis that, for a taxable year, is directly (or indirectly through one or more specified entities that are not corporations) taken into account for U.S. tax purposes by a U.S. tax resident, a CFC described in §1.267A–5(a)(17), or a specified foreign person and—

(*1*) Reduces the amount of the U.S. tax resident's taxable income, one or more categories of the CFC's positive subpart F income, the CFC's tested income, or the specified foreign person's ECTI, as applicable; or

(*2*) Prevents a decrease or offset of the amount of the CFC's tested loss or qualified deficits.

(B) *Rules for determining whether disqualified basis of an item of specified property is taken into account*. For purposes of paragraph (b)(4)(ii)(A) of this section, disqualified basis of an item of specified property is taken into account for U.S. tax purposes without regard to whether the disqualified basis is reduced or eliminated under §1.951A–3(h)(2)(ii)(B)(*1*).

(C) *Timing rules when disqualified basis gives rise to a deferred or disallowed loss*. To the extent disqualified basis of an item of specified property gives rise to a deduction or loss during a taxable year that is deferred, then the determination of whether the item of deduction or loss gives rise to a basis benefit amount under paragraph (b)(4)(ii)(A) of this section is made when the item of deduction or loss is no longer deferred. In addition, to the extent disqualified basis of an item of specified property gives rise to a deduction or loss during a taxable year that is disallowed under section 267(a)(1), then a basis benefit amount is treated as occurring in the taxable year when and to the extent that gain is reduced pursuant to section 267(d), and provided that the gain is described in paragraph (b)(4)(ii)(A) of this section.

(iii) *Rules for assigning a basis benefit amount to a taxable year of a section 245A shareholder*—(A) *In general*. For purposes of applying paragraph (b)(4)(i)(A) of this section with respect to a section 245A shareholder, a basis benefit amount with respect to an item of specified property is assigned to a taxable year of the section 245A shareholder if—

(*1*) With respect to the item of specified property, the ownership requirement of paragraph (b)(3)(i) of this section is satisfied for the taxable year of the section 245A shareholder; and

(*2*) The basis benefit amount occurs during the taxable year of the section 245A shareholder, or a taxable year of a

U.S. tax resident (other than the section 245A shareholder), a CFC described in §1.267A–5(a)(17), or a specified foreign person, as applicable, that—

(*i*) Ends with or within the taxable year of the section 245A shareholder; or

(*ii*) Begins with or within the taxable year of the section 245A shareholder, but only in a case in which but for this paragraph (b)(4)(iii)(A)(*2*)(*ii*) the basis benefit amount would not be assigned to a taxable year of the section 245A shareholder.

(B) *Anti-duplication rule.* For purposes of paragraph (b)(4)(i)(A) of this section, to the extent that disqualified basis of an item of specified property gives rise to a basis benefit amount that is assigned to a taxable year of a section 245A shareholder under paragraph (b)(4)(iii)(A) of this section, and thereafter such disqualified basis gives rise to an additional basis benefit amount, the additional basis benefit amount cannot be assigned to another taxable year of any section 245A shareholder. Thus, for example, if the entire amount of disqualified basis of an item of specified property gives rise to a basis benefit amount for a particular taxable year of a CFC and is assigned to a taxable year of a section 245A shareholder but, pursuant to §1.951A–3(h)(2)(ii)(B)(*1*)(*ii*), the disqualified basis is not reduced or eliminated in such taxable year of the CFC (because, for example, the buyer is a CFC that is a related party) and, as a result, the disqualified basis thereafter gives rise to an additional basis benefit amount, then no portion of the additional basis benefit amount is assigned to a taxable year of any section 245A shareholder.

(iv) *Successor rules for basis benefit accounts.* To the extent that an extraordinary disposition account of a section 245A shareholder is adjusted pursuant to §1.245A–5(c)(4), a basis benefit account with respect to the extraordinary disposition account is adjusted in a similar manner.

(5) *Special rules regarding duplicate DQB of an item of exchanged basis property*—(i) *Adjustments to certain rules in applying paragraph (b)(1) of this section.* For purposes of paragraph (b)(1) of this section for a taxable year of a section 245A shareholder, the following rules apply with respect to duplicate DQB of an item of exchanged basis property:

(A) Duplicate DQB of the item of exchanged basis property with respect to an item of specified property to which the item of exchanged property relates is not taken into account for purposes of paragraph (b)(1) of this section if the disqualified basis of the item of specified property is taken into account for purposes of paragraph (b)(1) of this section. Thus, for example, if for a taxable year of a section 245A shareholder the ownership requirement of paragraph (b)(3) of this section is satisfied with respect to an item of specified property and an item of exchanged basis property that relates to the item of specified property, all of the disqualified basis of which is duplicate DQB with respect to the item of specified property, then only the disqualified basis of the item of specified property is taken into account for purposes of, and is subject to reduction under, paragraph (b)(1) of this section.

(B) If, pursuant to paragraph (b)(5)(i)(A) of this section, duplicate DQB of an item of exchanged basis property with respect to an item of specified property is not taken into account for purposes of paragraph (b)(1) of this section, then, solely for purposes of §1.951A–2(c)(5), the duplicate DQB of the item of exchanged basis property is reduced (in the same manner as it would be if the disqualified basis were taken into account for purposes of paragraph (b)(1) of this section) by the product of the amounts described in paragraphs (b)(5)(i)(B)(*1*) and (*2*) of this section.

(*1*) The reduction, under paragraph (b)(1) of this section for the taxable year of the section 245A shareholder, to the disqualified basis of the item of specified property to which the item of exchanged basis property relates.

(*2*) A fraction, the numerator of which is the duplicate DQB of the item of exchanged basis property with respect to the item of specified property, and the denominator of which is the sum of the amounts of duplicate DQB with respect to the item of specified property of each item of exchanged basis property that relates to the item of specified property and for which the ownership requirement of paragraph (b)(3)(i) of this section is satisfied for the taxable year of the section 245A shareholder. For purposes of determining this fraction, duplicate DQB of an item of exchanged basis property is determined pursuant to the rules of paragraph (b)(2)(i) of this section (by replacing the term ''paragraph (b)(1)'' in that paragraph with the term ''paragraph (b)(5)(i)(B)''). In addition, duplicate DQB of an item of exchanged basis property is excluded from the denominator of the fraction to the extent the duplicate DQB is attributable to duplicate DQB of another item of exchanged basis property that is included in the denominator of the fraction.

(ii) *Adjustments to certain rules in applying paragraph (b)(4) of this section.* For purposes of paragraph (b)(4)(i)(A) of this section, to the extent that disqualified basis of an item of specified property gives rise to a basis benefit amount that is assigned to a taxable year of a section 245A shareholder under paragraph (b)(4)(iii)(A) of this section, and thereafter duplicate DQB attributable to such disqualified basis of the item of specified property gives rise to an additional basis benefit amount, the additional basis benefit amount cannot be assigned to another taxable year of any section 245A shareholder. Similarly, for purposes of paragraph (b)(4)(i)(A) of this section, to the extent that duplicate DQB attributable to disqualified basis of an item of specified property gives rise to a basis benefit amount that is assigned to a taxable year of a section 245A shareholder under paragraph (b)(4)(iii)(A) of this section, and thereafter such disqualified basis of the item of specified property (or duplicate DQB attributable to such disqualified basis of the item of specified property) gives rise to an additional basis benefit amount, the additional basis benefit amount cannot be assigned to another taxable year of any section 245A shareholder.

(6) *Special rule regarding prior extraordinary disposition amounts.* For purposes of paragraph (b)(1) of this section, to the extent that an extraordinary disposition account of a section 245A shareholder is reduced under §1.245A–5(c)(3)(i)(A) by reason of a prior extraordinary disposition amount described in §1.245A–5(c)(3)(i)(D)(*1*)(*i*) through (*iv*), the extraordinary disposition account is considered to give rise to an extraordinary disposition amount or tiered extraordinary disposition amount (and the amount by which the account is reduced is treated as an extraordinary disposition amount or tiered extraordinary disposition amount).

(c) *Reduction of extraordinary disposition account by reason of the allocation and apportionment of deductions or losses attributable to disqualified basis*—(1) *In general.* For a taxable year of a CFC, if there is an RGI account with respect to the CFC that relates to an extraordinary disposition account of a section 245A shareholder with respect to an SFC, and the section 245A shareholder satisfies the ownership requirement of paragraph (c)(5) of this section for the taxable year of the CFC, then, subject to the limitations in paragraphs (c)(6) and (7) of this section, the extraordinary disposition account is reduced (but not below zero) by the lesser of the following amounts (each determined in the functional currency of the CFC)—

(i) The excess (if any) of—

(A) The product of—

(*1*) The adjusted earnings of the CFC for the taxable year of the CFC; and

(*2*) The percentage of stock of the CFC (by value) that, in aggregate, is owned directly or indirectly through one or more specified entities by the section 245A shareholder and any domestic affiliates on the last day of the taxable year of the CFC; over

(B) The sum of—

(*1*) The sum of the balance of the section 245A shareholder's and any domestic affiliates' previously taxed earnings and profits accounts with respect to the CFC for purposes of section 959 (determined as of the end of the taxable year of the CFC and taking into account any adjustments to the accounts for the taxable year);

(*2*) The sum of the balance of the hybrid deduction accounts (as described in §1.245A(e)–1(d)(1)) with respect to shares of stock of the CFC that the section 245A shareholder and any domestic affiliates own (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) as of the end of the taxable year of the

CFC and taking into account any adjustments to the accounts for the taxable year; and

(*3*) The sum of the balance of the section 245A shareholder's and any domestic affiliates' extraordinary disposition accounts with respect to the CFC (determined as of the end of the taxable year of the CFC and taking into account any adjustments to the accounts for the taxable year). However, if the section 245A shareholder or a domestic affiliate has an RGI account with respect to the CFC that relates to an extraordinary disposition account with respect to the CFC, then only the excess, if any, of the balance of the extraordinary disposition account over the balance of the RGI account that relates to the extraordinary disposition account (determined as of the end of the taxable year of the CFC, but without regard to the application of paragraph (c)(4)(i)(B) of this section for the taxable year) is taken into account for purposes of this paragraph (c)(1)(i)(B)(*3*). In addition, for purposes of this paragraph (c)(1)(i)(B)(*3*), an extraordinary disposition account that but for paragraph (e)(1) of this section would be with respect to the CFC for purposes of this section is treated as an extraordinary disposition account with respect to the CFC and thus is taken into account for purposes of this paragraph (c)(1)(i)(B)(*3*).

(ii) The balance of the RGI account with respect to the CFC that relates to the section 245A shareholder's extraordinary disposition account with respect to the SFC (determined as of the end of the taxable year of the CFC, but without regard to the application of paragraph (c)(4)(i)(B) of this section for the taxable year).

(2) *Timing of reduction to extraordinary disposition account.* See §1.245A–9(b)(3) for timing rules regarding the reduction to an extraordinary disposition account.

(3) *Adjusted earnings.* The term *adjusted earnings* means, with respect to a CFC and a taxable year of the CFC, the earnings and profits of the CFC, determined as of the end of the CFC's taxable year (taking into account all distributions during the taxable year, and not taking into account any deficit in earnings and profits subject to §1.381(c)(2)–1(a)(5)) and with the adjustments described in paragraphs (c)(3)(i) through (iv) of this section.

(i) The earnings and profits are increased by the amount of any deduction or loss that—

(A) Is or was attributable to disqualified basis of an item of specified property, but only to the extent that gain recognized on the extraordinary disposition of the item of specified property was included in the initial balance of an extraordinary disposition account;

(B) Is or was allocated and apportioned to residual CFC gross income of the CFC (or a predecessor) solely by reason of §1.951A–2(c)(5)(i); and

(C) Does not or has not given rise to or increased a deficit in earnings and profits subject to §1.381(c)(2)–1(a)(5), determined as of the end of the taxable year of the CFC.

(ii) The earnings and profits are decreased by the amount by which any RGI account with respect to the CFC has been decreased pursuant to paragraph (c)(4)(i)(B) of this section for a prior taxable year of the CFC.

(iii) The earnings and profits are determined without regard to earnings attributable to income described in section 245(a)(5)(A) or dividends described in section 245(a)(5)(B) (determined without regard to section 245(a)(12)).

(iv) The earnings and profits are decreased by the amount of any deduction or loss that, but for paragraph (c)(3)(i)(C) of this section, would be described in paragraph (c)(3)(i) of this section.

(4) *RGI account*—(i) *In general.* For a taxable year of a CFC, the following rules apply to determine the balance of a section 245A shareholder's RGI account that is with respect to the CFC and that relates to an extraordinary disposition account of the section 245A shareholder with respect to an SFC:

(A) The balance of the RGI account is increased by the product of the amounts described in paragraphs (c)(4)(i)(A)(*1*) and (2) of this section for a taxable year of the CFC.

(*1*) The sum of the amounts of deductions and losses of the CFC that—

(*i*) Are attributable to disqualified basis of one or more items of specified property that correspond to the extraordinary disposition account; and

(*ii*) But for §1.951A–2(c)(5)(i), would have decreased one or more categories of the CFC's positive subpart F income, the CFC's tested income, or the CFC's ECTI, or increased or given rise to a tested loss or one or more qualified deficits of the CFC.

(*2*) The lesser of—

(*i*) A fraction (expressed as a percentage), the numerator of which is the sum of the portions of the CFC's subpart F income and tested income or tested loss (expressed as a positive number) taken into account under sections 951(a)(1)(A) and 951A(a) (as determined under the rules of §§1.951–1(b) and (e) and 1.951A–1(d)) by the section 245A shareholder and any domestic affiliates of the section 245A shareholder and the section 245A shareholder's and any domestic affiliates' pro rata shares of the CFC's qualified deficits (expressed as a positive number), and the denominator of which is the sum of the CFC's subpart F income, tested income or tested loss (expressed as a positive number), and qualified deficits (expressed as a positive number), but for purposes of this paragraph (c)(4)(i)(A)(*2*)(*i*) treating ECTI (expressed as a positive number) as if it were subpart F income; and

(*ii*) The extraordinary disposition ownership percentage applicable as to the section 245A shareholder's extraordinary disposition account.

(B) The balance of the RGI account is decreased to the extent that, by reason of the application of paragraph (c)(1) of this section with respect to the taxable year of the CFC, there is a reduction to the extraordinary disposition account of the section 245A shareholder.

(ii) *Successor rules for RGI accounts.* To the extent that an extraordinary disposition account of a section 245A shareholder is adjusted pursuant to §1.245A–5(c)(4), an RGI account of a CFC with respect to the extraordinary disposition account is adjusted in a similar manner.

(5) *Ownership requirement with respect to a CFC.* For a taxable year of a CFC, a section 245A shareholder satisfies the ownership requirement of this paragraph (c)(5) if, on the last day of the CFC's taxable year, the section 245A shareholder or a domestic affiliate is a United States shareholder with respect to the CFC.

(6) *Allocation of reductions among multiple extraordinary disposition accounts.* This paragraph (c)(6) applies if, by reason of the application of paragraph (c)(1) of this section with respect to a taxable year of a CFC (and but for the application of this paragraph (c)(6) and paragraph (c)(7) of this section), the sum of the reductions under paragraph (c)(1) of this section to two or more extraordinary disposition accounts of a section 245A shareholder or a domestic affiliate of the section 245A shareholder would exceed the amount described in paragraph (c)(1)(i)(A) of this section (the amount of such excess, the *excess amount*). When this paragraph (c)(6) applies, the reduction to each extraordinary disposition account described in the previous sentence is equal to the reduction that would occur but for this paragraph (c)(6) and paragraph (c)(7) of this section, less the product of the excess amount and a fraction, the numerator of which is the balance of the extraordinary disposition account, and the denominator of which is the sum of the balances of all of the extraordinary dispositions accounts described in the previous sentence. For purposes of determining this fraction, the balance of an extraordinary disposition account is determined as of the end of the taxable year of the section 245A shareholder or the domestic affiliate, as applicable, that includes the date on which the CFC's taxable year ends (and after the determination of any extraordinary disposition amounts or tiered extraordinary disposition amounts for the taxable year of the section 245A shareholder or the domestic affiliate, as applicable, and adjustments to the extraordinary disposition account for prior extraordinary disposition amounts).

(7) *Extraordinary disposition account not reduced below balance of basis benefit account.* An extraordinary disposition account of a section 245A shareholder cannot be reduced pursuant to paragraph (c)(1) of this section below the balance of the basis benefit account with respect to the extraordinary disposition account (determined when a

reduction to the extraordinary disposition account would occur under paragraph (c)(1) of this section).

(d) *Special rules for determining when specified property corresponds to an extraordinary disposition account*—(1) *Substituted property*—(i) *Treatment as specified property that corresponds to an extraordinary disposition account.* For purposes of this section, an item of substituted property is treated as an item of specified property that corresponds to an extraordinary disposition account to which the related item of specified property (that is, the item of specified property to which the item of substituted property relates, as described in paragraph (d)(1)(ii) of this section) corresponds. In addition, in a case in which an item of substituted property relates to an item of specified property that corresponds to a particular extraordinary disposition account and an item of specified property that corresponds to another extraordinary disposition account (such that, pursuant to this paragraph (d)(1)(i), the item of substituted property is treated as corresponding to multiple extraordinary disposition accounts), only the disqualified basis of the item of substituted property attributable to the first item of specified property is taken into account for purposes of applying this section as to the first extraordinary disposition account, and, similarly, only the disqualified basis of the item of substituted property attributable to the second item of specified property is taken into account for purposes of applying this section as to the second extraordinary disposition account.

(ii) *Definition of substituted property.* The term *substituted property* means an item of property the disqualified basis of which is, pursuant to §1.951A–3(h)(2)(ii)(B)(*2*)(*i*) or (*iii*), increased by reason of a reduction under §1.951A–3(h)(2)(ii)(*B*)(*1*) in disqualified basis of an item of specified property. An item of substituted property relates to an item of specified property if the disqualified basis of the item of substituted property was increased by reason of a reduction in disqualified basis of the item of specified property.

(2) *Exchanged basis property*—(i) *Treatment as specified property that corresponds to an extraordinary disposition account for certain purposes.* For purposes of this section, an item of exchanged basis property is treated as an item of specified property that corresponds to an extraordinary disposition account to which the related item of specified property (that is, the item of specified property to which the item of exchanged basis property relates) corresponds.

(ii) *Definition of exchanged basis property.* The term *exchanged basis property* means an item of property the disqualified basis of which, pursuant to §1.951A–3(h)(2)(ii)(B)(*2*)(*ii*), includes disqualified basis of an item of specified property. An item of exchanged basis property relates to an item of specified property if the disqualified basis of the item of exchanged basis property includes disqualified basis of the item of specified property.

(iii) *Definition of duplicate DQB*—(A) *In general.* The term *duplicate DQB* means, with respect to an item of exchanged basis property and the item of specified property to which the exchanged basis property relates, the disqualified basis of the item of exchanged basis property that includes or is attributable to disqualified basis of the item of specified property.

(B) *Certain nonrecognition transfers involving stock or a partnership interest.* To the extent that an item of exchanged basis property that is stock or an interest in a partnership (*lower-tier item*) includes disqualified basis of an item of specified property to which the lower-tier item relates (*contributed item*), and another item of exchanged basis property that is stock or a partnership interest (*upper-tier item*) includes disqualified basis of the lower-tier item that is attributable to disqualified basis of the contributed item, the disqualified basis of the upper-tier item is attributable to disqualified basis of the contributed item and the upper-tier item is an item of exchanged basis property that relates to the contributed item. The principles of the preceding sentence apply each time disqualified basis of an item of exchanged basis property that is stock or an interest in a partnership is included in disqualified basis of another item of exchanged basis property that is stock or an interest in a partnership.

(C) *Multiple nonrecognition transfers of an item of specified property.* To the extent that multiple items of exchanged basis property that are stock or interests in a partnership include disqualified basis of the same item of specified property (*contributed item*) to which the items of exchanged basis property relate, and the issuer of one of the items of exchanged basis property (*upper-tier successor item*) receives the other item of exchanged basis property (*lower-tier successor item*) in exchange for the contributed property, the disqualified basis of the upper-tier successor item is attributable to disqualified basis of the lower-tier successor item and the upper-tier successor item is an item of exchanged basis property that relates to the lower-tier successor item. The principles of the preceding sentence apply each time disqualified basis of an item of specified property to which an item of exchanged basis property that is stock or an interest in partnership relates is included in disqualified basis of another item of exchanged basis property that is stock or an interest in a partnership.

(e) *Special rules when extraordinary disposition accounts are adjusted pursuant to §1.245A–5(c)(4)*—(1) *Extraordinary disposition account with respect to multiple SFCs.* This paragraph (e)(1) applies if, pursuant to §1.245A–5(c)(4)(ii) or (iii) (the transaction or transactions by reason of which §1.245A–5(c)(4)(ii) or (iii) applies, the *adjustment transaction*), an extraordinary disposition account of a section 245A shareholder with respect to an SFC (such extraordinary disposition account, the *transferor ED account;* and such SFC, the *transferor SFC*) gives rise to an increase in the balance of an extraordinary disposition account with respect to another SFC (such extraordinary disposition account, the *transferee ED account;* such SFC, the *transferee SFC;* and such increase, the *adjustment amount*). When this paragraph (e)(1) applies, the following rules apply for purposes of this section:

(i) A ratable portion of the transferee ED account is treated as retaining its status as an extraordinary disposition account with respect to the transferor SFC and is not treated as an extraordinary disposition account with respect to the transferee SFC (the transferee ED account to such extent, the *deemed transferor ED account*), based on the adjustment amount relative to the balance of the transferee ED account (without regard to this paragraph (e)(1)) immediately after the adjustment transaction. Thus, for example, whether or not the transferor SFC is in existence immediately after the transaction, the items of specified property that correspond to the deemed transferor ED account are the same as the items of specified property that correspond to the transferor ED account. As an additional example, whether or not the transferor SFC is in existence immediately after the transaction the extraordinary disposition ownership percentage with respect to the deemed transferor ED account is the same as the extraordinary disposition ownership percentage with respect to the transferor ED account (except to the extent the extraordinary disposition ownership percentage is adjusted pursuant to the rules of paragraph (e)(2) of this section).

(ii) In the case of an amount (such as an extraordinary disposition amount or tiered extraordinary disposition amount) determined by reference to the transferee ED account (without regard to this paragraph (e)(1)), the portion of the amount that is considered attributable to the deemed transferor ED account (and not the transferee ED account) is equal to the product of such amount and a fraction, the numerator of which is the balance of the deemed transferor ED account, and the denominator of which is the balance of the transferee ED account (determined without regard to this paragraph (e)(1)). Thus, for example, if after an adjustment transaction the transferee ED account (without regard to this paragraph (e)(1)) gives rise to an extraordinary disposition amount, and if the fraction (expressed as a percentage) is 40, then, for purposes of this section, 40 percent of the extraordinary disposition amount is treated as attributable to the deemed transferor ED account and the remaining 60 percent of the extraordinary disposition amount is attributable to the transferee ED account, and the balance of each of the deemed transferor ED account and the transferee ED account is correspondingly reduced.

(2) *Extraordinary disposition accounts with respect to a single SFC.* If an extraordinary disposition account of a section 245A shareholder with respect to an SFC is reduced by reason of §1.245A–5(c)(4), then, except as provided in paragraph (e)(1) of this section, for purposes of this section, the extraordinary disposition ownership percentage as to the extraordinary disposition account (as well as the extraordinary disposition ownership percentage as to any extraordinary disposition account with respect to the SFC that is increased by reason of the reduction) is adjusted in a similar manner.

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A–9 Other rules and definitions.

(a) *In general.* This section provides rules of general applicability for purposes of §§1.245A–6 through 1.245A–10, a transition rule to revoke an election to eliminate disqualified basis, and definitions.

(b) *Rules of general applicability*—(1) *Correspondence.* An item of specified property corresponds to a section 245A shareholder's extraordinary disposition account if gain was recognized on the extraordinary disposition of the item and the gain was taken into account in determining the initial balance of the account. See §1.245A–8(d) for additional rules regarding when an item of property is treated as corresponding to an extraordinary disposition account in certain complex cases.

(2) *Timing rules related to disqualified basis for purposes of applying §§1.245A–7(b) and 1.245A–8(b)*—(i) *Determination of disqualified basis.* For purposes of determining the fraction described in §1.245A–7(b)(1)(ii) or §1.245A–8(b)(1)(ii) when applying §1.245A–7(b)(1) or §1.245A–8(b)(1)(ii), respectively, for a taxable year of a section 245A shareholder, disqualified basis of an item of specified property is determined as of the beginning of the taxable year of the CFC that holds the item of specified property (in a case in which §1.245A–7(b) applies) or the specified property owner (in a case in which §1.245A–8(b) applies), in either case, that includes the date on which the section 245A shareholder's taxable year ends (and without regard to any reductions to the disqualified basis of the item of specified property pursuant to §1.245A–7(b)(1) or §1.245A–8(b)(1) for such taxable year of the CFC or the specified property owner, as applicable). However, if disqualified basis of the item of specified property arose as a result of an extraordinary disposition that occurred after the beginning of the taxable year of the CFC or the specified property owner described in the preceding sentence, then the disqualified basis of the item of specified property is determined as of the date on which the extraordinary disposition occurred (and without regard to any reductions to the disqualified basis of the item of specified property pursuant to paragraph (b)(1) of this section for such taxable year of the CFC or the specified property owner).

(ii) *Reduction to disqualified basis of an item of specified property.* The reduction to disqualified basis of an item of specified property pursuant to §1.245A–7(b)(1) or §1.245A–8(b)(1) occurs on the date described in paragraph (b)(2)(i) of this section.

(iii) *Definition of specified property owner.* For purposes of applying §1.245A–8(b)(1) and paragraphs (b)(2)(i) and (ii) of this section for a taxable year of a section 245A shareholder, the term *specified property owner* means, with respect to an item of specified property, the person that, on at least one day of the taxable year of the person that includes the date on which the section 245A shareholder's taxable year ends, held the item of specified property. However, if, but for this sentence, there would be more than one specified property owner with respect to the item of specified property, then the specified property owner is the person that held the item of specified property on the earliest date that falls within the section 245A shareholder's taxable year.

(3) *Timing rules for reducing an extraordinary disposition account under §§1.245A–7(c) and 1.245A–8(c).* For purposes of §1.245A–7(c)(1) or §1.245A–

8(c)(1), as applicable, with respect to a taxable year of a CFC, the reduction to an extraordinary disposition account pursuant to § 1.245A–7(c)(1) or § 1.245A–8(c)(1) occurs as of the end of the taxable year of the section 245A shareholder that includes the date on which the CFC's taxable year ends (and after the determination of any extraordinary disposition amounts or tiered extraordinary amounts, adjustments to the extraordinary disposition account for prior extraordinary disposition amounts, and the application of § 1.245A–7(b) or § 1.245A–8(b), as applicable, each for the taxable year of the section 245A shareholder).

(4) *Currency translation.* For purposes of applying §§ 1.245A–7(b) and 1.245A–8(b), the disqualified basis of (and, if applicable, a basis benefit amount with respect to) an item of specified property that corresponds to an extraordinary disposition account are translated (if necessary) into the functional currency in which the extraordinary disposition account is maintained, using the spot rate on the date the extraordinary disposition occurred. A reduction in disqualified basis of an item of specified property determined under § 1.245A–7(b)(1) or § 1.245A–8(b)(1) is translated (if necessary) into the functional currency in which the disqualified basis of the item of specified property is maintained, and a reduction in an extraordinary disposition account determined under § 1.245A–7(c) or § 1.245A–8(c) section is translated (if necessary) into the functional currency in which the extraordinary disposition account is maintained, in each case using the spot rate described in the preceding sentence.

(5) *Anti-avoidance rule.* Appropriate adjustments are made pursuant to this paragraph (b)(5), including adjustments that would disregard a transaction or arrangement in whole or in part, to any amounts determined under (or subject to application of) this section if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of §§ 1.245A–6 through 1.245A–10.

(c) *Transition rule to revoke election to eliminate disqualified basis*—(1) *In general.* This paragraph (c)(1) applies to an election that is filed, pursuant to § 1.951A–3(h)(2)(ii)(B)(*3*), to eliminate the disqualified basis of an item of specified property. An election to which this paragraph (c)(1) applies may be revoked if, on or before March 1, 2021—

(i) All controlling domestic shareholders (as defined in § 1.964–1(c)(5)) of the CFC (or, in the case of an election made by a partnership, the partnership) each attach a revocation statement (in the manner described in paragraph (c)(2) of this section) to an amended return, for the taxable year to which the election applies, that revokes the election (or, in the case of a partnership subject to subchapter C of chapter 63 of the Internal Revenue Code, requests administrative adjustment under section 6227); and

(ii) The controlling domestic shareholders (or the partnership) each file an amended tax return, for any other taxable years reflecting the election to eliminate the disqualified basis, that reflects the election having been revoked (or, in the case of a partnership subject to subchapter C of chapter 63, requests administrative adjustment under section 6227).

(2) *Revocation statement.* Except as otherwise provided in publications, forms, instructions, or other guidance, a revocation statement attached by a person to an amended tax return must include the person's name, taxpayer identification number, and a statement that the revocation statement is filed pursuant to paragraph (c)(1) of this section to revoke an election pursuant to § 1.951A–3(h)(2)(ii)(B)(*3*). In addition, the revocation statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(d) *Definitions.* In addition to the definitions in § 1.245A–5, the following definitions apply for purposes of §§ 1.245A–6 through 1.245A–11.

(1) The term *adjusted earnings* has the meaning provided in § 1.245A–7(c)(3) or § 1.245A–8(c)(3), as applicable.

(2) The term *basis benefit account* has the meaning provided in § 1.245A–8(b)(4)(i).

(3) The term *basis benefit amount* has the meaning provided in § 1.245A–8(b)(4)(ii).

(4) The term *disqualified basis* has the meaning provided in § 1.951A–3(h)(2)(ii).

(5) The term *domestic affiliate* means, with respect to a section 245A shareholder, a domestic corporation that is a related party with respect to the section 245A shareholder. *See also* § 1.245A–5(i)(19) (defining related party).

(6) The term *duplicate DQB* has the meaning provided in § 1.245A–8(d)(2)(iii).

(7) The term *ECTI* means, with respect to a taxable year of a specified foreign person, the taxable income (or loss) of the specified foreign person determined by taking into account only items of income and gain that are, or are treated as, effectively connected with the conduct of a trade or business in the United States (as described in § 1.882–4(a)(1)) and are not exempt from U.S. tax pursuant to a treaty obligation of the United States, and items of deduction and loss that are allocated and apportioned to such items of income and gain.

(8) The term *exchanged basis property* has the meaning provided in § 1.245A–8(d)(2)(ii).

(9) The term *qualified deficit* has the meaning provided in section 952(c)(1)(B)(ii).

(10) The term *qualified related party* has the meaning provided in § 1.245A–8(b)(3)(ii).

(11) The term *RGI account* means, with respect to a CFC and an extraordinary disposition account of a section 245A shareholder with respect to an SFC, an account of the section 245A shareholder with respect to an SFC (the initial balance of which is zero), adjusted at the end of each taxable year of the CFC pursuant to the rules of § 1.245A–7(c)(4) or § 1.245A–8(c)(4), as applicable. The RGI account must be maintained in the functional currency of the CFC.

(12) The term *specified foreign person* means a nonresident alien individual (as defined in section 7701(b) and the regulations under section 7701(b)) or a foreign corporation (including a CFC) that conducts, or is treated as conducting, a trade or business in the United States (as described in § 1.882–4(a)(1)).

(13) The term *specified property owner* has the meaning provided in § 1.245A–8(b)(2)(iii).

(14) The term *subpart F income* has the meaning provided in section 952(a).

(15) The term *substituted property* has the meaning provided in § 1.245A–8(d)(1)(ii).

(16) The term *tested income* has the meaning provided in section 951A(c)(2)(A).

(17) The term *tested loss* has the meaning provided in section 951A(c)(2)(B).

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A–10 Examples.

(a) *Scope*. This section provides examples illustrating the application of §§ 1.245A–6 through 1.245A–9.

(b) *Presumed facts*. For purposes of the examples in the section, except as otherwise stated, the following facts are presumed:

(1) US1 and US2 are both domestic corporations that have calendar taxable years.

(2) CFC1, CFC2, CFC3, and CFC4 are all SFCs and CFCs that have taxable years ending November 30.

(3) Each entity uses the U.S. dollar as its functional currency.

(4) There are no items of deduction or loss attributable to an item of specified property.

(5) Absent the application of § 1.245A–5, any dividends received by US1 from CFC1 would meet the requirements to qualify for the section 245A deduction.

(6) All dispositions of items of specified property by an SFC during a disqualified period of the SFC to a related party give rise to an extraordinary disposition.

(7) None of the CFCs have a deficit subject to § 1.381(c)(2)–1(a)(5), and none of the CFCs are engaged in the conduct of a trade or business in the United States (and therefore none of the CFCs have ECTI).

(8) There is no previously taxed earnings and profits account with respect to any CFC for purposes of section 959. In addition, each hybrid deduction account with respect to a share of stock of a CFC has a zero balance at all times. Further, there is no extraordinary disposition account with respect to any CFC.

(9) Under § 1.245A–11(b), taxpayers choose to apply §§ 1.245A–6 through 1.245A–11 to the relevant taxable years.

(c) *Examples*—(1) *Example 1. Reduction of disqualified basis under rule for simple cases by reason of dividend paid out of extraordinary disposition account*—(i) *Facts.* US1 owns 100% of the single class of stock of CFC1 and CFC2. On November 30, 2018, in a transaction that is an extraordinary disposition, CFC1 sells two items of specified property, Item 1 and Item 2, to CFC2 in exchange for $150x of cash (the ''Disqualified Transfer''). Item 1 is sold for $90x and Item 2 is sold for $60x. Item 1 and Item 2 each has a basis of $0 in the hands of CFC1 immediately before the Disqualified Transfer, and therefore CFC1 recognizes $150x of gain as a result of the Disqualified Transfer ($150× − $0). After the Disqualified Transfer, CFC2's only assets are Item 1 and Item 2. On November 30, 2018, and thus during US1's taxable year ending December 31, 2018, CFC1 distributes $150x of cash to US1, and all of the distribution is characterized as a dividend under section 301(c)(1) and treated as a distribution out of earnings and profits described in section 959(c)(3). For CFC1's taxable year ending on November 30, 2018, CFC1 has $160x of earnings and profits described in section 959(c)(3), without regard to any distributions during the taxable year. CFC2 continues to hold Item 1 and Item 2. Lastly, because the conditions of §1.245A–6(b)(1) and (2) are satisfied for US1's 2018 taxable year, US1 chooses to apply §1.245A–7 (rules for simple cases) in lieu of §1.245A–8 (rules for complex cases) for that taxable year.

(ii) *Analysis*—(A) *Application of §§1.245A–5 and 1.951A–2 as a result of the Disqualified Transfer.* As a result of the Disqualified Transfer, under §1.951A–2(c)(5), Item 1 has disqualified basis of $90x, and Item 2 has disqualified basis of $60x. In addition, as a result of the Disqualified Transfer, under §1.245A–5(c)(3)(i)(A), US1 has an extraordinary disposition account with respect to CFC1 with an initial balance of $150x. Under §1.245A–5(c)(2)(i), $10x of the dividend is considered paid out of non-extraordinary disposition E&P of CFC1 with respect to US1, and $140x of the dividend is considered paid out of US1's extraordinary disposition account with respect to CFC1 to the extent of the balance of the extraordinary disposition account ($150x). Thus, the dividend of $150x is an extraordinary disposition amount, within the meaning of §1.245A–5(c)(1), to the extent of $140x. As a result, the balance of the extraordinary disposition account is reduced to $10x ($150× − $140x).

(B) *Correspondence requirement.* Under §1.245A–9(b)(1), each of Item 1 and Item 2 corresponds to US1's extraordinary disposition account with respect to CFC1, because as a result of the Disqualified Transfer CFC1 recognized gain with respect to Item 1 and Item 2, and the gain was taken into account in determining the initial balance of US1's extraordinary disposition account with respect to CFC1.

(C) *Reduction of disqualified basis of Item 1.* Because Item 1 corresponds to US1's extraordinary disposition account, the disqualified basis of Item 1 is reduced pursuant to §1.245A–7(b)(1) by reason of US1's $140x extraordinary disposition amount for US1's 2018 taxable year. Paragraphs (c)(2)(ii)(C)(*1*) through (*3*) of this section describe the determinations pursuant to §1.245A–7(b)(1).

(*1*) To determine the reduction to the disqualified basis of Item 1, the disqualified basis of Item 1, as well as the disqualified basis of Item 2, must be determined as of the date described in §1.245A–9(b)(2)(i) (and before the application of §1.245A–7(b)(1)). *See* §1.245A–7(b)(1)(ii). For each of Item 1 and Item 2, that date is December 1, 2018. December 1, 2018, is the first day of the taxable year of CFC2 (the CFC that holds Item 1 and Item 2) beginning on December 1, 2018, which is the taxable year of CFC2 that includes December 31, 2018, the date on which US1's 2018 taxable year ends. *See* §1.245A–9(b)(2)(i).

(*2*) Pursuant to §1.245A–7(b)(1), the disqualified basis of Item 1 is reduced by $84x, computed as the product of—

(*i*) $140x, the extraordinary disposition amount; and

(*ii*) A fraction, the numerator of which is $90x (the disqualified basis of Item 1 on December 1, 2018, and before the application of §1.245A–7(b)(1)), and the denominator of which is $150x (the disqualified basis of Item 1, $90x, plus the disqualified basis of Item 2, $60x, in each case determined on December 1, 2018, and before the application of §1.245A–7(b)(1)). *See* §1.245A–7(b)(1).

(*3*) The $84x reduction to the disqualified basis of Item 1 occurs on December 1, 2018, the date on which the disqualified basis of Item 1 is determined for purposes of determining the reduction pursuant to §1.245A–7(b)(1). *See* §1.245A–9(b)(2)(ii).

(D) *Reduction of disqualified basis of Item 2.* For reasons similar to those described in paragraph (c)(2)(ii)(C) of this section, on December 1, 2018, the disqualified basis of Item 2 is reduced by $56x, the amount equal to the product of $140x, the extraordinary disposition amount, and a fraction, the numerator of which is $60x (the disqualified basis of Item 2 on December 1, 2018, and before the application of §1.245A–7(b)(1)), and the denominator of which is $150x (the disqualified basis of Item 1, $90x, plus the disqualified basis of Item 2, $60x, in each case determined on December 1, 2018, and before the application of §1.245A–7(b)(1)).

(2) *Example 2. Basis benefit amount and impact on reduction to disqualified basis under rule for complex cases*—(i) *Facts.* The facts are the same as in paragraph (c)(1)(i) of this section (*Example 1*) (and the results are the same as in paragraph (c)(1)(ii)(A) of this section), except that, on December 1, 2018, CFC2

sells Item 1 for $90x of cash to an individual that is not a related party with respect to US1 or CFC2 (such transaction, the ''Sale,'' and such individual, ''Individual A''). At the time of the Sale, CFC2's basis in Item 1 is $90x (all of which is disqualified basis, as described in §1.951A–3(h)(2)(ii)(A)). CFC2 takes into the account the disqualified basis of Item 1 for purposes of determining the amount of gain recognized on the Sale, which is $0 ($90x − $90x); but for the disqualified basis, CFC2 would have had $90x of gain that would have been taken into account in computing its tested income. As a result of the Sale, the condition of §1.245A–6(b)(2) is not satisfied, because on at least one day of CFC2's taxable year beginning on December 1, 2018 (which begins within US1's 2018 taxable year) CFC2 does not hold Item 1. *See* §1.245A–6(b)(2)(ii)(C)(*1*). US1 therefore applies §1.245A–8 (rules for complex cases) for its 2018 taxable year. *See* §1.245A–6(b).

(ii) *Analysis*—(A) *Ownership requirement.* With respect to each of Item 1 and Item 2, the ownership requirement of §1.245A–8(b)(3)(i) is satisfied for US1's 2018 taxable year. This is because on at least one day that falls within US1's 2018 taxable year, each of Item 1 and Item 2 is held by CFC2, and US1 directly owns all of the stock of CFC2 throughout such taxable year (and thus, for purposes of applying §1.245A–8(b)(3)(i), US1 owns at least 10% of the interests of CFC2 on at least one day that falls within such taxable year). *See* §1.245A–8(b)(3).

(B) *Basis benefit amount with respect to Item 1 as a result of the Sale.* Under §1.245A–8(b)(4)(i), US1 has a basis benefit account with respect to its extraordinary disposition account with respect to CFC1. As described in paragraphs (c)(2)(ii)(B)(*1*) through (*3*) of this section, the balance of the basis benefit account (which is initially zero) is, on December 31, 2018, increased by $90x, the basis benefit amount with respect to Item 1 and assigned to US1's 2018 taxable year.

(*1*) By reason of the Sale, for CFC2's taxable year beginning December 1, 2018, and ending November 30, 2019, the entire $90x of disqualified basis of Item 1 is taken into account for U.S. tax purposes by CFC2 and, as a result, reduces CFC2's tested income or increases CFC2's tested loss. Accordingly, for such taxable year, there is a $90x basis benefit amount with respect to Item 1. *See* §1.245A–8(b)(4)(ii)(A). The result would be the same if the Sale were to a related person and thus, pursuant to §1.951A–3(h)(2)(ii)(B)(*1*)(*ii*), no portion of the $90x of disqualified basis were eliminated or reduced by reason of the Sale. *See* §1.245A–8(b)(4)(ii)(B).

(*2*) The $90x basis benefit amount with respect to Item 1 is assigned to US1's 2018 taxable year. This is because the ownership requirement of §1.245A–8(b)(3)(i) is satisfied with respect to Item 1 for US1's 2018 taxable year, and the basis benefit amount occurs in CFC2's taxable year beginning December 1, 2018, a taxable year of CFC2 that begins within US1's 2018 taxable year (and, but for §1.245A–8(b)(4)(iii)(A)(*2*)(*ii*), the basis benefit amount would not be assigned to a taxable year of US1, such as the taxable year of US1 beginning January 1, 2019, given that, as result of the Sale, the ownership requirement of §1.245A–8(b)(3)(i) would not be satisfied with respect to Item 1 for such taxable year). *See* §1.245A–8(b)(4)(iii)(A).

(*3*) On December 31, 2018 (the last day of US1's 2018 taxable year), US1's basis benefit account with respect to its extraordinary disposition account with respect to CFC1 is increased by $90x, the $90x basis benefit amount with respect to Item 1 and assigned to US1's 2018 taxable year. The basis benefit account is increased by such amount because Item 1 corresponds to US1's extraordinary disposition account with respect to CFC1, and the extraordinary disposition ownership percentage applicable to such extraordinary disposition account is 100. *See* §1.245A–8(b)(4)(i)(A).

(C) *Basis benefit amount limitation on reduction to disqualified basis.* By reason of US1's $140x extraordinary disposition amount for US1's 2018 taxable year, the disqualified basis of Item 1 is reduced by $30x, and the disqualified basis of Item 2 is reduced by $20x, pursuant to §1.245A–8(b)(1). *See* §1.245A–8(b). Paragraphs (c)(2)(ii)(C)(*1*) through (*4*) of this section describe the determinations pursuant to §1.245A–8(b)(1).

(*1*) For purposes of determining the reduction to the disqualified bases of Item 1 and Item 2, the disqualified bases of the Items are determined on December 1, 2018 (and before the application of §1.245A–8(b)(1)). *See* §1.245A–8(b)(1)(ii). The disqualified bases of the Items are determined on December 1, 2018, because that date is the first day of the taxable year of CFC2 beginning on December 1, 2018, which is the taxable year of CFC2 (the specified property owner of each of Item 1 and Item 2) that includes December 31, 2018, the date on which US1's 2018 taxable year ends. *See* §1.245A–8(b)(2)(i). For purposes of applying §§1.245A–8(b)(1) and §1.245A–9(b)(2) for US1's 2018 taxable year, CFC2 is the specified property owner of each of Item 1 and Item 2 because, on at least one day of CFC2's taxable year that includes the date on which US1's 2018 taxable year ends (that is, on at least one day of CFC2's taxable year beginning December 1, 2018), CFC2 held the Item. *See* §1.245A–9(b)(2)(iii). CFC2 is the specified property owner of Item 1 even though Individual A also held Item 1 during Individual A's taxable year that includes the date on which US1's 2018 taxable year ends because CFC2 held Item 1 on an earlier date than Individual A. *See* §1.245A–9(b)(2)(iii).

(*2*) Pursuant to §1.245A–8(b)(1), the disqualified basis of Item 1 is reduced by $30x, computed as the product of—

(*i*) $50x, the excess of the extraordinary disposition amount ($140x) over the balance of the basis benefit account with respect to US1's extraordinary disposition with respect to CFC1 ($90x); and

(*ii*) A fraction, the numerator of which is $90x (the disqualified basis of Item 1 on December 1, 2018, and before the application of §1.245A–8(b)(1)), and the denominator of which is $150x (the disqualified basis of Item 1, $90x, plus the disqualified basis of Item 2, $60x, in each case determined on December 1, 2018, and before the application of §1.245A–8(b)(1)). *See* paragraph §1.245A–8(b)(1).

(*3*) Pursuant to §1.245A–8(b)(1), the disqualified basis of Item 2 is reduced by $20x, computed as the product of—

(*i*) $50x, the excess of the extraordinary disposition amount ($140x) over the balance of the basis benefit account with respect to US1's extraordinary disposition with respect to CFC1 ($90x); and

(*ii*) A fraction, the numerator of which is $60x (the disqualified basis of Item 2 on December 1, 2018, and before the application of paragraph (b)(1) of this section), and the denominator of which is $150x (the disqualified basis of Item 1, $90x, plus the disqualified basis of Item 2, $60x, in each case determined on December 1, 2018, and before the application of §1.245A–8(b)(1)). *See* §1.245A–8(b)(1).

(*4*) The $30x and $20x reductions to the disqualified bases of Item 1 and Item 2, respectively, occur on December 1, 2018, the date on which the disqualified bases of the Items are determined for purposes of determining the reductions pursuant to §1.245A–8(b)(1). *See* §1.245A–9(b)(2)(ii).

(D) *Reduction of basis benefit account.* The balance of the basis benefit account with respect to US1's extraordinary disposition account with respect to CFC1 is decreased by $90x, the amount by which, for CFC2's taxable year beginning December 1, 2018, the disqualified bases of Item 1 and Item 2 would have been reduced pursuant to §1.245A–8(b)(1) but for the $90x balance of the basis benefit account. *See* §1.245A–8(b)(4)(i)(B). The reduction to the balance of the basis benefit account occurs on December 31, 2018, and after the completion of all other computations pursuant to §1.245A–8(b). *See* §1.245A–8(b)(4)(i)(B).

(3) *Example 3. Reduction in balance of extraordinary disposition account under rules for simple cases by reason of allocation and apportionment of deductions to residual CFC gross income*—(i) *Facts.* The facts are the same as in paragraph (c)(1)(i) of this section (*Example 1*) (and the results are the same as in paragraph (c)(1)(ii)(A) of this section), except that CFC1 does not make a distribution to US1. In addition, during CFC2's taxable year beginning December 1, 2018, and ending November 30, 2019, the disqualified basis of Item 1 gives rise to a $6x amortization deduction, and the disqualified basis of Item 2 gives rise to a $4x amortization deduction, and each of the amortization deductions is allocated and apportioned to residual CFC gross income of CFC2 solely by reason of §1.951A–2(c)(5) (though, but for §1.951A–2(c)(5), would have been allocated and apportioned to gross tested income of CFC2). Further, as of the end of CFC2's taxable year ending November 30, 2019, CFC2 has $15x of earnings and profits. Lastly, because the conditions of §1.245A–6(b)(1) and (2) are satisfied for US1's 2018 taxable year, US1 chooses to apply §1.245A–7 (rules for simple cases) in lieu of §1.245A–8 (rules for complex cases) for that taxable year.

(ii) *Analysis.* Pursuant to §1.245A–7(c)(1), US1's extraordinary disposition account with respect to CFC1 is reduced by the lesser of the amount described in §1.245A–7(c)(1)(i) with respect to US1, and the RGI account of US1 with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1. *See* §1.245A–7(c)(1). Paragraphs (c)(3)(ii)(A) through (D) of this section describe the determinations pursuant to §1.245A–8(c)(1).

(A) *Computation of adjusted earnings of CFC2, and amount described in §1.245A–7(c)(1)(i) with respect to US1.* To determine the amount described in §1.245A–7(c)(1)(i) with respect to US1, the adjusted earnings of CFC2 must be computed for CFC2's taxable year ending November 30, 2019. *See* §1.245A–7(c)(1)(i). Paragraphs (c)(3)(ii)(A)(*1*) and (*2*) of this section describe these determinations.

(*1*) The adjusted earnings of CFC2 for its taxable year ending November 30, 2019, is $25x, computed as $15x (CFC2's earnings and profits as of November 30, 2019, the last day of that taxable year), plus $10x (the sum of the $6x and $4x amortization deductions of CFC2 for that taxable year, which is the amount of all deductions or losses of CFC2 that is or was attributable to disqualified basis of items of specified property and allocated and apportioned to residual CFC gross income of CFC2 solely by reason of §1.951A–2(c)(5)(i)). *See* §1.245A–7(c)(3).

(*2*) For CFC2's taxable year ending November 30, 2019, the amount described in §1.245A–7(c)(1)(i) with respect to US1 is $25x, computed as the excess of $25x (the adjusted earnings) over $0 (the sum of the balance of the previously taxed earnings and profits accounts with respect to CFC2).

(B) *Increase to balance of RGI account.* Under §1.245A–9(d)(11), US1 has an RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1. On November 30, 2019 (the last day of CFC2's taxable year), the balance of the RGI account (which is initially zero) is increased by $10x, the sum of the $6x and $4x amortization deductions of CFC2 for its taxable year ending November 30, 2019. *See* §1.245A–7(c)(4)(i). Each of the amortization deductions is taken into account for this purpose because, but for §1.951A–2(c)(5)(i), the deduction would have decreased CFC2's tested income or increased or given rise to a tested loss of CFC2. *See* §1.245A–7(c)(4)(i).

(C) *Reduction in balance of extraordinary disposition account.* Pursuant to §1.245A–7(c)(1), US1's extraordinary disposition account with respect to CFC1 is reduced by $10x, the lesser of the amount described in §1.245A–7(c)(1)(i) with respect to US1 for CFC2's taxable year ending November 30, 2019 ($25x), and the balance of US1's RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1 ($10x, determined as of November 30, 2019, but without regard to the application of §1.245A–7(c)(4)(ii) for the taxable year of CFC2 ending on that date). *See* §1.245A–7(c)(1). The $10x reduction in the balance of US1's extraordinary disposition account occurs on December 31, 2019, the last day of US1's taxable year that includes November 30, 2019 (the last day of CFC2's taxable year). *See* §1.245A–9(c)(3).

(D) *Reduction in balance of RGI account.* On November 30, 2019 (the last day of CFC2's taxable year), the balance of US1's RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1 is decreased by $10x, the amount of the reduction, pursuant to §1.245A–7(c)(1) section and by reason of the RGI account, to US1's extraordinary disposition account with respect to CFC1. *See* §1.245A–7(c)(4)(ii). Therefore, following that reduction, the balance of the RGI account is zero ($10x − $10x).

(iii) *Alternative facts in which the reduction is limited by earnings and profits.* The facts are the same as in paragraph (c)(3)(i) of this section (*Example 3*), except that CFC2 has a $5x deficit in its earnings and profits as of the end of its taxable year ending November 30, 2019. In this case—

(A) The adjusted earnings of CFC2 for its taxable year ending November 30, 2019, is $5x, computed as −$5x (CFC2's deficit in earnings and profits as of November 30, 2019) plus $10x (the sum of the $6x and $4x amortization deductions of CFC2), *see* §1.245A–7(c)(3);

(B) The amount described in §1.245A–7(c)(1)(i) with respect to US1 for CFC's taxable year ending November 30, 2019, is $5x, computed as the excess of $5x (the adjusted earnings) over $0 (the sum of the balance of the previously taxed earnings and profits accounts with respect to CFC2), *see* §1.245A–7(c)(1)(i);

(C) On December 31, 2019, US1's extraordinary disposition account with respect to CFC1 is reduced by $5x, the lesser of the amount described in §1.245A–7(c)(1)(i) with respect to US1 for CFC2's taxable year ending November 30, 2019 ($5x), and the balance of US1's RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1 ($10x, determined as of November 30, 2019, but without regard to the application of §1.245A–8(c)(4)(i)(B) for the taxable year of CFC2 ending on that date), *see* §§1.245A–7(c)(1) and 1.245A–9(c)(3); and

(D) On November 30, 2019 (the last day of CFC2's taxable year), the balance of US1's RGI account with respect to CFC2 is decreased by $5x (the amount of the reduction, pursuant to §1.245A–7(c)(1) and by reason of the RGI account, to US1's extraordinary disposition account with respect to CFC1) and, therefore, following such reduction, the balance of the RGI account is $5x ($10x − $5x), *see* §1.245A–7(c)(4)(ii).

(4) *Example 4. Reduction to extraordinary disposition accounts limited by §1.245A–8(c)(6)*—(i) *Facts.* The facts are the same as in paragraph (c)(3)(iii) of this section (*Example 3,* alternative facts in which the reduction is limited by earnings and profits) (and the results are the same as in paragraph (c)(1)(ii)(A) of this section), except that US1 also owns 100% of the stock of US2, which owns 100% of the stock of CFC3, and on November 30, 2018, in a transaction that was an extraordinary disposition, CFC3 sold an item of specified property (''Item 3'') to CFC2 in exchange for $200x of cash. Item 3 had a basis of $0 in the hands of CFC3 immediately before the sale and, therefore, CFC3 recognized $200x of gain as a result of the sale ($200x − $0), Item 3 has $200x of disqualified basis under §1.951A–2(c)(5), and US2 has an extraordinary disposition account with respect to CFC3 with an initial balance of $200x under §1.245A–5(c)(3)(i)(A). Moreover, during CFC2's taxable year beginning December 1, 2018, and ending November 30, 2019, the disqualified basis of Item 3 gives rise to a $20x amortization deduction, which is allocated and apportioned to residual CFC gross income of CFC2 solely by reason of §1.951A–2(c)(5) (though, but for §1.951A–2(c)(5), would have been allocated and apportioned to gross tested income of CFC2). Further, as of the end of US1's 2018 taxable year, the balance of US1's basis benefit account with respect to its extraordinary disposition account with respect to CFC1 is $0; similarly, as of the end of US2's 2018 taxable year, the balance of US2's basis benefit account with respect to its extraordinary disposition account with respect to CFC2 is $0. Because CFC2 holds items of specified property that correspond to more than one extraordinary disposition account (that is, Item 1 and Item 2 correspond to US1's extraordinary disposition account with respect to CFC2, and Item 3 corresponds to US2's extraordinary disposition account with respect to CFC2), the condition of §1.245A–6(b)(2) is not satisfied. *See* §1.245A–6(b)(2)(ii)(C)(*3*). US1 and US2 therefore apply §1.245A–8 (rules for complex cases) for their 2018 taxable years.

(ii) *Analysis.* Pursuant to §1.245A–8(c)(1), US1's extraordinary disposition account with respect to CFC1 is, subject to the limitation in §1.245A–8(c)(6), reduced by the lesser of the amount described in § 1.245A–8(c)(1)(i) with respect to US1, and the RGI account of US1 with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1. *See* § 1.245A–8(c)(1). Similarly, US2's extraordinary disposition account with respect to CFC3 is, subject to the limitation in § 1.245A–8(c)(6), reduced by the lesser of the amount described in § 1.245A–8(c)(1)(i) with respect to US2, and the RGI account of US2 with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC3. *See* § 1.245A–8(c)(1). Paragraphs (c)(4)(ii)(A) through (F) of this section describe the determinations pursuant to § 1.245A–8(c)(1).

(A) *Ownership requirement.* Each of US1 and US2 satisfy the ownership requirement of § 1.245A–8(c)(5) for CFC2's taxable year ending November 30, 2019, because on the last day of that taxable year each is a United States shareholder with respect to CFC2. *See* § 1.245A–8(c)(5).

(B) *Computation of adjusted earnings of CFC2, and amount described in § 1.245A–8(c)(1)(i) with respect to US1 and US2.* The adjusted earnings of CFC2 for its taxable year ending November 30, 2019, is $25x, computed as −$5x (CFC2's deficit in earnings and profits as of November 30, 2019), plus $30x (the sum of the $6x, $4x, and $20x amortization deductions of CFC2). *See* § 1.245A–8(c)(3). For CFC2's taxable year ending November 30, 2019, the amount described in § 1.245A–8(c)(1)(i) with respect to US1 is $25x, computed as the excess of the product of $25x (the adjusted earnings) and 100% (the percentage of the stock of CFC2 that US1 and its domestic affiliate, US2, own), over $0 (the sum of the balance of certain previously taxed earnings and profits accounts and hybrid deduction accounts). *See* § 1.245A–8(c)(1)(i). Similarly, for CFC2's taxable year ending November 30, 2019, the amount described in § 1.245A–8(c)(1)(i) with respect to US2 is $25x, computed as the excess of the product of $25x (the adjusted earnings) and 100% (the percentage of the stock of CFC2 that US2 and its domestic affiliate, US1, own), over $0 (the sum of the balance of certain previously taxed earnings and profits accounts and hybrid deduction accounts). *See* § 1.245A–8(c)(1)(i).

(C) *Increase to balance of RGI account.* As described in paragraph (c)(3)(ii)(B) of this section, US1 has an RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1, and the balance of the RGI account is $10x on November 30, 2019 (the last day of CFC2's taxable year). Similarly, US2 has an RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC3, and the balance of the RGI account is $20x on November 30, 2019 (reflecting a $20x increase to the balance of the account for the $20x amortization deduction of CFC2 for its taxable year ending November 30, 2019). *See* § 1.245A–8(c)(4)(i).

(D) *Reduction in balance of extraordinary disposition accounts but for § 1.245A–8(c)(6).* But for the application of § 1.245A–8(c)(6), US1's extraordinary disposition account with respect to CFC2 would be reduced by $10x, which is the lesser of $25x, the amount described in § 1.245A–8(c)(1)(i) with respect to US1 for CFC2's taxable year ending November 30, 2019, and $10x, the balance of the RGI account of US1 with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1 (determined as of November 30, 2019, but without regard to the application of § 1.245A–8(c)(4)(i)(B) for the taxable year of CFC2 ending on that date). *See* § 1.245A–8(c)(1)(i) and (ii). Similarly, but for the application of § 1.245A–8(c)(6), US2's extraordinary disposition account with respect to CFC3 would be reduced by $20x, which is the lesser of $25x, the amount described in § 1.245A–8(c)(1)(i) with respect to US2 for CFC2's taxable year ending November 30, 2019, and $20x, the balance of the RGI account of US2 with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC3 (determined as of November 30, 2019, but without regard to the application of § 1.245A–8(c)(4)(i)(B) for the taxable year of CFC2 ending on that date). *See* § 1.245A–8(c)(1)(i) and (ii).

(E) *Application of limitation of § 1.245A–8(c)(6).* As described in paragraph (c)(4)(ii)(D) of this section, but for the application of § 1.245A–8(c)(6), there would be a total of $30x of reductions to US1's extraordinary disposition account with respect to CFC1, and US2's extraordinary disposition account with respect to CFC3, by reason of the application of § 1.245A–8(c)(1) with respect to CFC2's taxable year ending November 30, 2019. Because that $30x exceeds the amount described in § 1.245A–8(c)(1)(i) with respect to US1 and US2 ($25x)—

(*1*) US1's extraordinary disposition account with respect to CFC1 is reduced by $7.86x, computed as $10x (the reduction that would occur but for § 1.245A–8(c)(6)) less the product of $5x (the excess amount, computed as $30x, the total reductions that would occur but for the application of § 1.245A–8(c)(6), less $25x, the amount described in § 1.245A–8(c)(1)(i)) and a fraction, the numerator of which is $150x (the balance of US1's extraordinary disposition account with respect to CFC1) and the denominator of which is $350x ($150x, the balance of US1's extraordinary disposition account with respect to CFC1, plus $200x, the balance of US2's extraordinary disposition account with respect to CFC3), *see* § 1.245A–8(c)(6); and

(*2*) US2's extraordinary disposition account with respect to CFC3 is reduced by $17.14x, computed as $20x (the reduction that would occur but for § 1.245A–8(c)(6)) less the product of $5x (the excess amount, computed as $30x, the total reductions that would occur but for the application of §1.245A–8(c)(6), less $25x, the amount described in §1.245A–8(c)(1)(i)) and a fraction, the numerator of which is $200x (the balance of US2's extraordinary disposition account with respect to CFC3) and the denominator of which is $350x ($150x, the balance of US1's extraordinary disposition account with respect to CFC1, plus $200x, the balance of US2's extraordinary disposition account with respect to CFC3), *see* §1.245A–8(c)(6) of this section.

(F) *Reduction in balance of RGI accounts.* On November 30, 2019 (the last day of CFC2's taxable year)—

(*1*) The balance of US1's RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC1 is decreased by $7.86x (the amount of the reduction, pursuant to §1.245A–8(c)(1) and by reason of the RGI account, to US1's extraordinary disposition account with respect to CFC1) and, thus, following that reduction, the balance of the RGI account is $2.14x ($10x − $7.86x), *see* §1.245A–8(c)(4)(i)(B); and

(*2*) The balance of US2's RGI account with respect to CFC2 that relates to its extraordinary disposition account with respect to CFC3 is decreased by $17.14x (the amount of the reduction, pursuant to §1.245A–8(c)(1) and by reason of the RGI account, to US2's extraordinary disposition account with respect to CFC3) and, thus, following that reduction, the balance of the RGI account is $2.86x ($20x − $17.14x), *see* §1.245A–8(c)(4)(i)(B).

(5) *Example 5. Computation of duplicate DQB*—(i) *Facts.* The facts are the same as in paragraph (c)(1)(i) of this section (*Example 1*) (and the results are the same as in paragraph (c)(1)(ii)(A) of this section), except that CFC1 does not make any distribution to US1, and on November 30, 2018, immediately after the Disqualified Transfer, CFC2 transfers Item 1 to newly-formed CFC3 solely in exchange for the sole share of stock of CFC3 (the contribution, ''Contribution 1,'' and the share of stock of CFC3, the ''CFC3 Share'') and, immediately after Contribution 1, CFC3 transfers Item 1 to newly-formed CFC4 solely in exchange for the sole share of stock of CFC4 (the contribution, ''Contribution 2,'' and the share of stock of CFC4, the ''CFC4 Share''). Pursuant to section 358(a)(1), CFC2's basis in its share of stock of CFC3 is $90x, and CFC3's basis in its share of stock of CFC4 is $90x basis. As a result of Contribution 1, the condition of §1.245A–6(b)(2) is not satisfied, because on at least one day of CFC2's taxable year ending on November 30, 2018 (which ends within US1's 2018 taxable year), CFC2 does not hold Item 1. *See* §1.245A–6(b)(2)(ii)(C)(*1*). US1 therefore applies §1.245A–8 (rules for complex cases) for its 2018 taxable year. *See* §1.245A–6(b).

(ii) *Analysis*—(A) *Application of exchanged basis rule under section 951A to Contribution 1 and Contribution 2.* As a result of Contribution 1, pursuant to §1.951A–3(h)(2)(ii)(B)(*2*)(*ii*), the disqualified basis of CFC3 Share includes the disqualified basis of Item 1 ($90x), and therefore the disqualified basis of CFC3 Share is $90x. Similarly, as a result of Contribution 2, pursuant to §1.951A–3(h)(2)(ii)(B)(*2*)(*ii*), the disqualified basis of CFC4 Share also includes the disqualified basis of Item 1 ($90x), and therefore the disqualified basis of CFC4 Share is $90x.

(B) *Determination of duplicate DQB of CFC3 Share as a result of Contribution 1.* Because the disqualified basis of CFC3 Share includes the disqualified basis of Item 1, CFC3 Share is an item of exchanged basis property that relates to Item 1. *See* §1.245A–8(d)(2)(ii). In addition, because CFC3 Share is an item of exchanged basis property that relates to Item 1 (which corresponds to US1's extraordinary disposition account with respect to CFC1), CFC3 Share is, for purposes of §1.245A–8, treated as an item of specified property that corresponds to US1's extraordinary disposition account with respect to CFC1. *See* §1.245A–8(d)(2)(i). Further, the duplicate DQB of CFC3 Share as to Item 1 is $90x, the portion of the disqualified basis of CFC3 Share that includes Item 1's disqualified basis of $90x. *See* §1.245A–8(d)(2)(iii)(A).

(C) *Determination of duplicate DQB of CFC4 Share as a result of Contribution 2.* For reasons similar to those described in paragraph (c)(5)(ii)(B) of this section, CFC4 Share is an item of exchanged basis property that relates to Item 1, CFC4 is treated for purposes of §1.245A–8 as an item of specified property that corresponds to US1's extraordinary disposition account with respect to CFC1, and the duplicate DQB of CFC4 Share as to Item 1 is $90x.

(D) *Determination of duplicate DQB of CFC3 Share as a result of Contribution 2.* Because the disqualified basis of CFC3 Share and the disqualified basis of CFC4 Share each includes $90x of the disqualified basis of Item 1 and CFC3 receives the CFC4 Share in Contribution 2, the $90x of disqualified basis of CFC3 Share is attributable to the $90x of disqualified basis of CFC4 Share, and CFC3 Share is an item of exchanged basis property that relates to CFC4 Share. *See* §1.245A–8(d)(2)(i) and (d)(2)(iii)(C). In addition, the duplicate DQB of CFC3 Share as to CFC4 Share is $90x. *See* §1.245A–8(d)(2)(iii)(A).

(E) *Application of duplicate basis rules in §1.245A–8(b)(5).* For purposes of computing the fraction described in §1.245A–8(b)(1)(ii), if US1's extraordinary disposition account with respect to CFC1 were to give rise to an extraordinary disposition amount or a tiered extraordinary disposition amount during US1's 2018 taxable year, then the duplicate DQB of CFC3 Share and the duplicate DQB of CFC4 Share would not be taken into account, because the disqualified basis of Item 1 (an item of specified property that corresponds to US1's extraordinary disposition account and as to which each of CFC3 Share and CFC4 share relates) would be taken into account. *See* §1.245A–8(b)(1)(ii) and (b)(5)(i)(A). Accordingly, in such a case, for US1's 2018 taxable year, the numerator of the fraction described in §1.245A–8(b)(1)(ii) would reflect only the disqualified basis of Item 1 or Item 2, as applicable, and the denominator would reflect only the sum of the disqualified basis of each of Item 1 and Item 2. *See* §1.245A–8(b)(1)(ii) and (b)(5)(i)(A). Furthermore, to the extent there were to be a reduction under §1.245A–8(b)(1) to the disqualified basis of Item 1, then the duplicate DQB of CFC4 Share would be reduced (but not below zero) by the product of the reduction to the disqualified basis of Item 1 and a fraction, the numerator of which would be $90x (the duplicate DQB of CFC4 Share), and the denominator of which would also be $90x (the duplicate DQB of CFC4 Share). *See* §1.245A–8(b)(5)(i)(B). The $90x of duplicate DQB of CFC3 Share would be excluded from the denominator of the fraction described in the previous sentence because it is attributable to the $90x of duplicate DQB of CFC4 Share. *See* §1.245A–8(b)(5)(i)(B)(*2*) (last sentence). For reasons similar to those described in this paragraph (c)(4)(ii)(E) with respect to the application of §1.245A–8(b)(5)(i)(B) to CFC4 Share, the duplicate DQB of CFC3 Share would be reduced (but not below zero) by the product of the reduction to the disqualified basis of Item 1 and a fraction, the numerator of which would be $90x, and the denominator of which would also be $90x.

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A–11 Applicability dates.

(a) *In general.* Sections 1.245A–6 through 1.245A–11 apply to taxable years of a foreign corporation beginning on or after December 1, 2020 and to taxable years of section 245A shareholders in which or with which such taxable years end.

(b) *Exception.* Notwithstanding paragraph (a) of this section, a taxpayer may choose to apply §§1.245A–6 through 1.245A–11 for a taxable year of a foreign corporation beginning before December 1, 2020 and to a taxable year of a section 245A shareholder in which or with which such taxable year ends, provided that the taxpayer and all persons bearing a relationship to the taxpayer described in section 267(b) or 707(b) apply §§1.245A–6 through 1.245A–11, in their entirety, and §1.6038–2(f)(18) for all such taxable years and any subsequent taxable years beginning before December 1, 2020.

[T.D. 9934, 85 FR 76963, Dec. 1, 2020]

§ 1.245A(d)–1 Disallowance of foreign tax credit or deduction.

(a) *No foreign tax credit or deduction allowed under section 245A(d)*–(1) *Foreign income taxes paid or accrued by domestic corporations or successors.* No credit under section 901 or deduction is allowed in any taxable year for:

(i) Foreign income taxes paid or accrued by a domestic corporation that are attributable to section 245A(d) income of the domestic corporation;

(ii) Foreign income taxes paid or accrued by a successor to a domestic corporation that are attributable to section 245A(d) income of the successor; and

(iii) Foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation, other than a foreign corporation that is a passive foreign investment company (as defined in section 1297) with respect to the domestic corporation and that is not a controlled foreign corporation, that are attributable to non-inclusion income of the foreign corporation and are not otherwise disallowed under paragraph (a)(1)(i) or (ii) of this section.

(2) *Foreign income taxes paid or accrued by foreign corporations.* No credit under section 901 or deduction is allowed in any taxable year for foreign income taxes paid or accrued by a foreign corporation that are attributable to section 245A(d) income, and such taxes are not eligible to be deemed paid under section 960 in any taxable year.

(3) *Effect of disallowance on earnings and profits.* The disallowance of a credit or deduction for foreign income taxes under this paragraph (a) does not affect whether the foreign income taxes reduce earnings and profits of a corporation.

(b) *Attribution of foreign income taxes*—(1) *Section 245A(d) income.* Foreign income taxes are attributable to section 245A(d) income to the extent that the foreign income taxes are allocated and apportioned under §1.861–20 to the section 245A(d) income group. For purposes of this paragraph (b)(1), §1.861–20 is applied by treating the section

245A(d) income group in each section 904 category of a domestic corporation, successor, or foreign corporation as a statutory grouping and treating all other income, including the receipt of a distribution of previously taxed earnings and profits other than section 245A(d) PTEP, as income in the residual grouping. See §1.861–20(d)(2) through (3) for rules regarding the allocation and apportionment of foreign income taxes to the statutory and residual groupings if the taxpayer does not realize, recognize, or take into account a corresponding U.S. item in the U.S. taxable year in which the foreign income taxes are paid or accrued. In the case of a foreign law distribution or foreign law disposition, a corresponding U.S. item is assigned to the statutory and residual groupings under §1.861–20(d)(2)(ii)(B) and (C) without regard to the application of section 246(c), the holding periods described in sections 964(e)(4)(A) and 1248(j), and §1.245A–5.

(2) *Non-inclusion income of a foreign corporation*—(i) *Scope.* This paragraph (b)(2) provides rules for attributing foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation to non-inclusion income of the foreign corporation. It applies only in cases in which the foreign income taxes are allocated and apportioned under §1.861–20 by reference to the characterization of the tax book value of stock, whether the stock is held directly or indirectly through a partnership or other passthrough entity, for purposes of allocating and apportioning the domestic corporation's interest expense, or by reference to the income of a foreign corporation that is a reverse hybrid or foreign law CFC.

(ii) *Foreign income taxes on a remittance, U.S. return of capital amount, or U.S. return of partnership basis amount.* This paragraph (b)(2)(ii) applies to foreign income taxes paid or accrued by a domestic corporation that is a United States shareholder of a foreign corporation with respect to foreign taxable income that the domestic corporation includes by reason of a remittance, a distribution (including a foreign law distribution) that is a U.S. return of capital amount or U.S. return of partnership basis amount, or a disposition (including a foreign law disposition) that gives rise to a U.S. return of capital amount or a U.S. return of partnership basis amount. These foreign income taxes are attributable to non-inclusion income of the foreign corporation to the extent that they are allocated and apportioned to the domestic corporation's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, or section 245A subgroup of U.S. source category stock in applying §1.861–20 for purposes of section 904 as the operative section. For purposes of this paragraph (b)(2)(ii), §1.861–20 is applied by treating the domestic corporation's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, and section 245A subgroup of U.S. source category stock as the statutory groupings and treating the tax book value of the non-section 245A subgroup of stock for each separate category as tax book value in the residual grouping.

(iii) *Foreign income taxes on income of a reverse hybrid or a foreign law CFC.* This paragraph (b)(2)(iii) applies to foreign income taxes paid or accrued by a domestic corporation, other than a regulated investment company (as defined in section 851), real estate investment trust (as defined in section 856), or S corporation (as defined in section 1361), that is a United States shareholder of a foreign corporation that is a reverse hybrid or foreign law CFC with respect to the foreign law pass-through income or foreign law inclusion regime income of the reverse hybrid or foreign law CFC, respectively. These taxes are attributable to the non-inclusion income of a reverse hybrid or foreign law CFC to the extent that they are allocated and apportioned to the non-inclusion income group under §1.861–20. For purposes of this paragraph (b)(2)(iii), §1.861–20 is applied by treating the non-inclusion income group in each section 904 category of the domestic corporation and the foreign corporation as a statutory grouping and treating all other income as income in the residual grouping.

(3) *Anti-avoidance rule.* Foreign income taxes are treated as attributable to section 245A(d) income of a domestic

corporation or foreign corporation, or non-inclusion income of a foreign corporation, if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) and this section with respect to such foreign income taxes, including, for example, by separating foreign income taxes from the income, or earnings and profits, to which such foreign income taxes relate or by making distributions (or causing inclusions) under foreign law in multiple years that give rise to foreign income taxes that are allocated and apportioned with reference to the same previously taxed earnings and profits. See paragraph (d)(4) of this section (*Example 3*).

(c) *Definitions.* The following definitions apply for purposes of this section.

(1) *Corresponding U.S. item.* The term *corresponding U.S. item* has the meaning set forth in §1.861–20(b).

(2) *Foreign income tax.* The term *foreign income tax* has the meaning set forth in §1.901–2(a).

(3) *Foreign law CFC.* The term *foreign law CFC* has the meaning set forth in §1.861–20(b).

(4) *Foreign law disposition.* The term *foreign law disposition* has the meaning set forth in §1.861–20(b).

(5) *Foreign law distribution.* The term *foreign law distribution* has the meaning set forth in §1.861–20(b).

(6) *Foreign law inclusion regime.* The term *foreign law inclusion regime* has the meaning set forth in §1.861–20(b).

(7) *Foreign law inclusion regime income.* The term *foreign law inclusion regime income* has the meaning set forth in §1.861–20(b).

(8) *Foreign law pass-through income.* The term *foreign law pass-through income* has the meaning set forth in §1.861–20(b).

(9) *Foreign taxable income.* The term *foreign taxable income* has the meaning set forth in §1.861–20(b).

(10) *Gross included tested income.* The term *gross included tested income* means, with respect to a foreign corporation that is described in paragraph (b)(2)(iii) of this section, an item of gross tested income multiplied by the inclusion percentage of a domestic corporation that is described in paragraph (b)(2)(iii) of this section for the domestic corporation's U.S. taxable year with or within which the foreign corporation's taxable year described in §1.861–20(d)(3)(i)(C) or §1.861–20(d)(3)(iii) ends.

(11) *Hybrid dividend.* The term *hybrid dividend* has the meaning set forth in §1.245A(e)–1(b)(2).

(12) *Inclusion percentage.* The term *inclusion percentage* has the meaning set forth in §1.960–1(b).

(13) *Non-inclusion income.* The term *non-inclusion income* means the items of gross income of a foreign corporation other than the items that are described in §1.960–1(d)(2)(ii)(B)(*2*) (items of income assigned to the subpart F income groups) and section 245(a)(5) (without regard to section 245(a)(12)), and other than gross included tested income.

(14) *Non-inclusion income group.* The term *non-inclusion income group* means the income group within a section 904 category that consists of non-inclusion income.

(15) *Non-section 245A subgroup.* The term *non-section 245A subgroup* means each non-section 245A subgroup determined under §1.861–13(a)(5), applied as if the foreign corporation whose stock is being characterized were a controlled foreign corporation.

(16) *Pass-through entity.* The term *pass-through entity* has the meaning set forth in §1.904–5(a)(4).

(17) *Remittance.* The term *remittance* has the meaning set forth in §1.861–20(d)(3)(v)(E).

(18) *Reverse hybrid.* The term *reverse hybrid* has the meaning set forth in §1.861–20(b).

(19) *Section 245A subgroup.* The term *section 245A subgroup* means each section 245A subgroup determined under §1.861–13(a)(5), applied as if the foreign corporation whose stock is being characterized were a controlled foreign corporation.

(20) *Section 245A(d) income.* With respect to a domestic corporation, the term *section 245A(d) income* means a dividend (including a section 1248 dividend and a dividend received indirectly through a pass-through entity) or an inclusion under section 951(a)(1)(A) for which a deduction under section 245A(a) is allowed, a distribution of section 245A(d) PTEP, a hybrid dividend, or an inclusion under section 245A(e)(2) and §1.245A(e)–1(c)(1) by reason of a

tiered hybrid dividend. With respect to a successor of a domestic corporation, the term *section 245A(d) income* means the receipt of a distribution of section 245A(d) PTEP. With respect to a foreign corporation, the term *section 245A(d) income* means an item of subpart F income that gave rise to a deduction under section 245A(a), a tiered hybrid dividend or a distribution of section 245A(d) PTEP. An item described in this paragraph (c)(20) that qualifies for the deduction under section 245A(a) is considered section 245A(d) income regardless of whether the domestic corporation claims the deduction on its return with respect to the item.

(21) *Section 245A(d) income group.* The term *section 245A(d) income group* means an income group within a section 904 category that consists of section 245A(d) income.

(22) *Section 245A(d) PTEP.* The term *section 245A(d) PTEP* means previously taxed earnings and profits described in §1.960–3(c)(2)(v) or (ix) if such previously taxed earnings and profits arose either as a result of a dividend that gave rise to a deduction under section 245A(a), or as a result of a tiered hybrid dividend that, by reason of section 245A(e)(2) and §1.245A(e)–1(c)(1), gave rise to an inclusion in the gross income of a United States shareholder. For purposes of this paragraph (c)(22), a dividend that qualifies for the deduction under section 245A(a) is considered to have given rise to a deduction under section 245A(a) regardless of whether the domestic corporation claims the deduction on its return with respect to the dividend.

(23) *Section 904 category.* The term *section 904 category* has the meaning set forth in §1.960–1(b).

(24) *Section 1248 dividend.* The term *section 1248 dividend* means an amount of gain that is treated as a dividend under section 1248.

(25) *Successor.* The term successor means a person, including an individual who is a citizen or resident of the United States, that acquires from any person any portion of the interest of a United States shareholder in a foreign corporation for purposes of section 959(a).

(26) *Tested income.* The term *tested income* has the meaning set forth in §1.960–1(b).

(27) *Tiered hybrid dividend.* The term *tiered hybrid dividend* has the meaning set forth in §1.245A(e)–1(c)(2).

(28) *U.S. capital gain amount.* The term *U.S. capital gain amount* has the meaning set forth in §1.861–20(b).

(29) *U.S. return of capital amount.* The term *U.S. return of capital amount* has the meaning set forth in §1.861–20(b).

(30) *U.S. return of partnership basis amount.* The term *U.S. return of partnership basis amount* means, with respect to a partnership in which a domestic corporation is a partner, the portion of a distribution by the partnership to the domestic corporation, or the portion of the proceeds of a disposition of the domestic corporation's interest in the partnership, that exceeds the U.S. capital gain amount.

(d) *Examples.* The following examples illustrate the application of this section.

(1) *Presumed facts.* Except as otherwise provided, the following facts are presumed for purposes of the examples:

(i) USP is a domestic corporation;

(ii) CFC is a controlled foreign corporation organized in Country A, and is not a reverse hybrid or a foreign law CFC;

(iii) USP owns all of the outstanding stock of CFC;

(iv) USP would be allowed a deduction under section 245A(a) for dividends received from CFC;

(v) All parties have a U.S. dollar functional currency and a U.S. taxable year and foreign taxable year that correspond to the calendar year; and

(vi) References to income are to gross items of income, and no party has deductions for Country A tax purposes or deductions for Federal income tax purposes (other than foreign income tax expense).

(2) *Example 1: Distribution for foreign and Federal income tax purposes—(i) Facts.* As of December 31, Year 1, CFC has $800x of section 951A PTEP (as defined in §1.960–3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960–3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). On December 31, Year 1, CFC distributes $1,000x of cash to USP. For Country A

tax purposes, the entire $1,000x distribution is a dividend and is therefore a foreign dividend amount (as defined in §1.861–20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income under Country A law. For Federal income tax purposes, USP includes in gross income $200x of the distribution as a dividend for which a deduction is allowable under section 245A(a). The remaining $800x of the distribution is a distribution of PTEP that is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. The entire $1,000x dividend is a U.S. dividend amount (as defined in §1.861–20(b)).

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP, or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861–20. Section 1.861–20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861–20(d). Section 1.861–20(d)(3)(i) assigns foreign gross income that is a foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. The $1,000x foreign dividend amount is therefore assigned to the statutory and residual groupings to which the $1,000x U.S. dividend amount is assigned under Federal income tax law. The $1,000x U.S. dividend amount comprises a $200x dividend for which a deduction under section 245A(a) is allowed, which is an item of section 245A(d) income, and $800x of section 951A PTEP, the receipt of which is income in the residual grouping. Accordingly, $200x of the $1,000x of foreign gross dividend income is assigned to the section 245A(d) income group, and $800x is assigned to the residual grouping. Under §1.861–20(f), $30x ($150x × $200x/$1,000x) of the $150x Country A withholding tax is apportioned to the section 245A(d) income group and is attributable to the section 245A(d) income of USP. The remaining $120x ($150x × $800x/$1,000x) of the tax is apportioned to the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income*. Under paragraph (b)(2) of this section, the $150x Country A withholding tax may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861–20 by reference to either the characterization of the tax book value of stock under §1.861–9 or the income of a foreign corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the $150x Country A withholding tax is allocated and apportioned under §1.861–20 by reference to the characterization of the tax book value of CFC's stock. See §1.861–20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Disallowance*. Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $30x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP.

(3) *Example 2: Distribution for foreign law purposes*—(i) *Facts*. As of December 31, Year 1, CFC has $800x of section

951A PTEP (as defined in §1.960–3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960–3(c)(1)), and $500x of earnings and profits described in section 959(c)(3). On December 31, Year 1, CFC distributes $1,000x of its stock to USP. For Country A tax purposes, the entire $1,000x stock distribution is treated as a dividend to USP and is therefore a foreign dividend amount (as defined in §1.861–20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income that USP includes under Country A law. For Federal income tax purposes, USP does not recognize gross income as a result of the stock distribution under section 305(a). The $1,000x stock distribution is therefore a foreign law distribution.

(ii) *Analysis*—(A) *In general*. The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income*. Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861–20. Section 1.861–20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861–20(d). In general, §1.861–20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. If a taxpayer does not recognize a corresponding U.S. item in the year in which it pays or accrues foreign income tax with respect to foreign gross income that it includes by reason of a foreign law dividend, §1.861–20(d)(2)(ii)(B) assigns the foreign dividend amount to the same statutory or residual groupings to which the foreign dividend amount would be assigned if a distribution were made for Federal income tax purposes in the amount of, and on the date of, the foreign law distribution. Further, §1.861–20(d)(2)(ii)(B) computes the U.S. dividend amount (as defined in §1.861–20(b)) as if the distribution occurred on the date the distribution occurs for foreign law purposes. Therefore, the foreign dividend amount is assigned to the same statutory and residual groupings to which it would be assigned if a $1,000x distribution occurred on December 31, Year 1 for Federal income tax purposes. If such a distribution occurred, it would result in a $200x dividend to USP for which a deduction would be allowed under section 245A(a). The remaining $800x of the distribution would be excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. Under paragraphs (c)(20) and (b)(1) of this section, the $1,000x U.S. dividend amount comprises a $200x dividend for which a deduction under section 245A(a) would be allowed, which is an item of section 245A(d) income, and $800x of section 951A PTEP, which is income in the residual grouping. Accordingly, $200x of the $1,000x foreign gross dividend income is assigned to the section 245A(d) income group, and $800x is assigned to the residual grouping. Under §1.861–20(f), $30x ($150x × $200x/$1,000x) of the Country A foreign income tax is apportioned to the section 245A(d) income group and is attributable to the section 245A(d) income of USP. The remaining $120x ($150x × $800x/$1,000x) of the tax is apportioned to the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income*. Under paragraph (b)(2) of this section, the $150x

Country A withholding tax may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861–20 by reference to either the characterization of the tax book value of stock under §1.861–9 or the income of a foreign corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the $150x Country A withholding tax is allocated and apportioned under §1.861–20 by reference to the characterization of the tax book value of CFC's stock. See §1.861–20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Disallowance.* Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $30x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP.

(4) *Example 3: Successive foreign law distributions subject to anti-avoidance rule*—(i) *Facts.* For Year 1, CFC earns $500x of subpart F income that gives rise to a $500x gross income inclusion to USP under section 951(a), and income that creates $500x of earnings and profits described in section 959(c)(3). CFC earns no income in Years 2 through 4. As of January 1, Year 2, and through December 31, Year 4, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP (as defined in §1.960–3(c)(2)(x)) in a single annual PTEP account (as defined in §1.960–3(c)(1)). In each of Years 2 and 3, USP makes a consent dividend election under Country A law that, for Country A tax purposes, deems CFC to distribute to USP, and USP immediately to contribute to CFC, $500x on December 31 of each year. For Country A tax purposes, each deemed distribution is a dividend of $500x to USP, and each deemed contribution is a non-taxable contribution of $500x to the capital of CFC. Each $500x deemed distribution is therefore a foreign dividend amount (as defined in §1.861–20(b)). Country A imposes $150x of withholding tax on USP in each of Years 2 and 3 with respect to the $500x of foreign gross dividend income that USP includes in income under Country A law. For Federal income tax purposes, the Country A deemed distributions in Years 2 and 3 are disregarded such that USP recognizes no income, and the deemed distributions are therefore foreign law distributions. On December 31, Year 4, CFC distributes $1,000x to USP, which for Country A tax purposes is treated as a return of contributed capital on which no withholding tax is imposed. For Federal income tax purposes, $500x of the $1,000x distribution is a dividend to USP for which a deduction under section 245A(a) is allowed; the remaining $500x of the distribution is a distribution of section 951(a)(1)(A) PTEP that is excluded from USP's gross income and not treated as a dividend under section 959(a) and (d), respectively. The entire $1,000x dividend is a U.S. dividend amount (as defined in §1.861–20(b)). The Country A consent dividend elections in Years 2 and 3 are made with a principal purpose of avoiding the purposes of section 245A(d) and this section to disallow a credit or deduction for Country A withholding tax incurred with respect to USP's section 245A(d) income.

(ii) *Analysis*—(A) *In general.* The rules of this section are applied by first determining the portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. Finally, the anti-avoidance rule under paragraph (b)(3) of this section applies to treat any portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 as attributable to section 245A(d) income of USP or non-inclusion income of CFC, if a transaction, series of related transactions, or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(d) and this section. No credit or deduction is allowed in any taxable year under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income.* Under paragraph (b)(1) of this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861–20. Section 1.861–20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861–20(d). In general, §1.861–20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. If a taxpayer does not recognize a corresponding U.S. item in the year in which it pays or accrues foreign income tax with respect to foreign gross income that it includes by reason of a foreign law dividend, §1.861–20(d)(2)(ii)(B) assigns the foreign dividend amount to the same statutory or residual groupings to which the foreign dividend amount would be assigned if a distribution were made for Federal income tax purposes in the amount of, and on the date of, the foreign law distribution. Therefore, the $500x foreign dividend amount in each of Years 2 and 3 is assigned to the same statutory and residual groupings to which it would be assigned if a $500x distribution occurred on December 31 of each of those years for Federal income tax purposes.

(*1*) *Year 2 $500x deemed distribution.* CFC made no distributions in Year 1 and earned no income and made no distributions in Year 2 for Federal income tax purposes. As of December 31, Year 2, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP. If CFC distributed $500x on that date, the distribution would be a distribution of section 951(a)(1)(A) PTEP. A distribution of previously taxed earnings and profits is a U.S. dividend amount. Section 1.861–20(d)(3)(i) assigns the foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. The receipt of a distribution of previously taxed earnings and profits is assigned to the residual grouping under paragraph (b)(1) of this section. Therefore, all $500x foreign dividend amount would be assigned to the residual grouping, and none of the $150x withholding tax paid or accrued by USP in Year 2 would be treated as attributable to section 245A(d) income of USP.

(*2*) *Year 3 $500x deemed distribution.* CFC made no distributions in Year 1 and earned no income and made no distributions in Year 2 or Year 3 for Federal income tax purposes. Consequently, as of December 31, Year 3, CFC has $500x of earnings and profits described in section 959(c)(3) and $500x of section 951(a)(1)(A) PTEP. If CFC distributed $500x on that date, the distribution would be a distribution of section 951(a)(1)(A) PTEP. For the reasons described in paragraph (d)(4)(ii)(B)(*1*) of this section, all $500x of the foreign dividend amount would be assigned to the residual grouping, and none of the $150x withholding tax paid or accrued by USP in Year 3 would be treated as attributable to section 245A(d) income of USP.

(*3*) *Year 4 $1,000x distribution.* The Year 4 $1,000x distribution is, for Country A purposes, a return of capital distribution that is not subject to withholding tax. For Federal income tax purposes, it comprises a $500x dividend for which a deduction under section 245A(a) is allowed, which is an item of section 245A(d) income of USP, and a $500x distribution of section 951(a)(1)(A) PTEP, the receipt of which is income in the residual grouping.

(C) *Attribution of foreign income taxes to non-inclusion income.* Under paragraph (b)(2) of this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 may be attributed to non-inclusion income of CFC if the tax is allocated and apportioned under §1.861–20 by reference to either the characterization of the tax book value of stock under §1.861–9 or the income of a foreign corporation that is a reverse hybrid or foreign law CFC. CFC is neither a reverse hybrid nor a foreign law CFC. In addition, no portion of the Country A withholding tax is allocated and apportioned under §1.861–20 by reference to the characterization of the tax book value of CFC's stock. See §1.861–20(d)(3)(i). Therefore, none of the tax is attributable to non-inclusion income of CFC.

(D) *Attribution of foreign income taxes pursuant to anti-avoidance rule.* USP made two successive foreign law distributions in Years 2 and 3 that were subject to Country A withholding tax and that did not individually exceed, but together exceeded, the section 951(a)(1)(A) PTEP of CFC. The Country A withholding tax on each consent dividend is allocated to the residual grouping rather than to the statutory grouping of section 245A(d) income under §§1.861–20(d)(2)(ii) and 1.861–20(d)(3)(i). USP paid no Country A withholding tax on the Year 4 distribution as a result of the Country A consent dividends in Years 2 and 3. If CFC had distributed its earnings and profits in Year 4 without the prior consent dividends, the distribution would have been subject to withholding tax, a portion of which would have been attributable to the section 245A(d) income arising from the distribution. But for the application of the anti-avoidance rule in paragraph (b)(3) of this section, USP would avoid the disallowance under section 245A(d) with respect to this portion of the withholding tax. Because USP made foreign law distributions that caused withholding tax from multiple foreign law distributions to be associated with the same previously taxed earnings and profits with a principal purpose of avoiding the purposes of section 245A(d) and this section, the $150x Country A withholding tax paid by USP in each of Years 2 and 3 is treated as being attributable to section 245A(d) income of USP.

(E) *Disallowance.* Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $150x Country A withholding tax paid by USP in each of Years 2 and 3 that is attributable to section 245A(d) income of USP.

(5) *Example 4: Distribution that is in part a dividend and in part a return of capital*—(i) *Facts.* CFC uses the modified gross income method to allocate and apportion its interest expense, and its stock has a tax book value of $10,000x. For Year 1, CFC earns $500x of income that is specified foreign source general category gross income as that term is defined in §1.861–13(a)(1)(i)(A)(*9*) and is therefore neither tested income nor subpart F income of CFC. As of December 31, Year 1, CFC has $500x of earnings and profits described in section 959(c)(3). On that date, CFC distributes $1,000x of cash to USP. For Country A tax purposes, the entire $1,000x distribution is a dividend to USP and is therefore a foreign dividend amount (as defined in §1.861–20(b)). Country A imposes a withholding tax on USP of $150x with respect to the $1,000x of foreign gross dividend income that USP includes under the law of Country A. For Federal income tax purposes, USP includes $500x of the distribution in its gross income as a dividend for which a $500x deduction is allowed to USP under section 245A(a); the remaining $500x of the distribution is applied against and reduces USP's basis in its CFC stock under section 301(c)(2). The portion of the distribution that is a $500x dividend is a U.S. dividend amount (as defined in §1.861–20(b)). The remaining $500x of the distribution is a U.S. return of capital amount.

(ii) *Analysis*—(A) *In general.* The rules of this section are applied by first determining the portion of the $150x Country A withholding tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A withholding tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (b)(2)(iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed under paragraph (a)(1)(i) of this section for any portion of the $150x Country A withholding tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income.* Under paragraph (b)(1) of this section, the $150x Country A withholding tax is attributable to the section 245A(d) income of USP to the extent that it is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861–20. Section 1.861–20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861–20(d). Section 1.861–20(d)(3)(i) assigns foreign gross income that is a foreign dividend amount, to the extent of the U.S. dividend amount, to the statutory and residual groupings to which the U.S. dividend amount is assigned. Of the $1,000x foreign dividend amount, $500x is therefore assigned to the statutory and residual groupings to which the $500x U.S. dividend amount is assigned under Federal income tax law. The entire $500x U.S. dividend amount is a dividend for which a section 245A(a) deduction is allowed and is therefore section 245A(d) income that is assigned to the section 245A(d) income group. Accordingly, $500x of the foreign dividend amount is assigned to the section 245A(d) income group. Under §1.861–20(f), $75x ($150x × $500x/$1,000x) of the Country A withholding tax is allocated to the section 245A(d) income group and so under paragraph (b)(1) of this section is attributable to the section 245A(d) income of USP.

(C) *Attribution of foreign income taxes to non-inclusion income.* The remaining $75x of the Country A withholding tax is described in paragraph (b)(2)(i) of this section because the $500x of foreign dividend amount that corresponds to the $500x U.S. return of capital amount is assigned, and the remaining withholding tax imposed on that foreign dividend amount is allocated and apportioned, by reference to the characterization of the tax book value of the stock of CFC. Under paragraph (b)(2)(ii) of this section, the remaining $75x Country A withholding tax is attributable to non-inclusion income of CFC to the extent that the tax is allocated and apportioned under §1.861–20 to USP's section 245A subgroup of general category stock, section 245A subgroup of passive category stock, and section 245A subgroup of U.S. source category stock (the statutory groupings) for purposes of section 904 as the operative section. Under §1.861–20(d)(3)(i), the $500x portion of the foreign dividend amount that corresponds to the $500x U.S. return of capital amount is assigned to the statutory and residual groupings to which $500x of earnings of CFC would be assigned if CFC recognized them in Year 1. Those earnings are deemed to arise in the statutory and residual groupings in the same proportions as the proportions of the tax book value of CFC's stock in the groupings for Year 1 for purposes of applying the asset method of expense allocation and apportionment under §1.861–9. Under §1.861–9, §1.861–9T(f), and §1.861–13, for purposes of section 904 as the operative section, all of the tax book value of the stock of CFC is assigned to USP's section 245A subgroup of general category stock because CFC uses the modified gross income method to allocate and apportion its interest expense and earns only specified foreign source general category gross income for Year 1. Under §1.861–20(d)(3)(i), if CFC recognized $500x of earnings in Year 1 these earnings would be deemed to arise in the section 245A subgroup of general category stock. Accordingly, the remaining $500x of foreign dividend amount is assigned to USP's section 245A subgroup of general category stock. Under §1.861–20(f), the remaining $75x of withholding tax is allocated to the section 245A subgroup and, under paragraph (b)(2)(ii) of this section, is attributable to the non-inclusion income of CFC.

(D) *Disallowance.* Under paragraph (a)(1)(i) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $75x portion of the Country A withholding tax that is attributable to section 245A(d) income of USP. Under paragraph (a)(1)(iii) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $75x portion of the Country A withholding tax that is attributable to non-inclusion income of CFC.

(6) *Example 5: Income of a reverse hybrid*—

(i) *Facts.* CFC is a reverse hybrid. In Year 1, CFC earns a $500x item of gain described in section 907(c)(1)(B) that is non-inclusion income. CFC also earns for Federal income tax purposes and Country A tax purposes a $1,000x item of royalty income, of which $500x is gross included tested income and $500x is non-inclusion income. USP includes the $500x item of foreign gain and the $1,000x item of foreign gross royalty income in its Country A taxable income, and the items are foreign law pass-through income. If CFC included these items under Country A tax law, its $1,000x of royalty income for Federal income tax purposes would be the corresponding U.S. item for the foreign gross royalty income, and its $500x of gain for Federal income tax purposes would be the corresponding U.S. item for the foreign gain. Country A imposes a $150x foreign income tax on USP with respect to $1,500x of foreign gross income.

(ii) *Analysis*—(A) *In general.* The rules of this section are applied by first determining the portion of the $150x Country A tax that is attributable under paragraph (b)(1) of this section to the section 245A(d) income of USP, and then by determining the portion of the $150x Country A tax that is described in paragraph (b)(2)(i) of this section and that is attributable under either paragraph (b)(2)(ii) or (iii) of this section to the non-inclusion income of CFC. No credit or deduction is allowed under paragraph (a)(1)(i) of this section for any portion of the $150x Country A tax that is attributable to the section 245A(d) income of USP or, under paragraph (a)(1)(iii) of this section, for any portion of that tax that is attributable to the non-inclusion income of CFC, to the extent the tax is not disallowed under paragraph (a)(1)(i) of this section.

(B) *Attribution of foreign income taxes to section 245A(d) income.* Under paragraph (b)(1) of this section, the $150x Country A tax is attributable to section 245A(d) income to the extent the tax is allocated and apportioned to the section 245A(d) income group (the statutory grouping) under §1.861–20. Section 1.861–20(c) allocates and apportions foreign income tax to the statutory and residual groupings to which the items of foreign gross income that were included in the foreign tax base are assigned under §1.861–20(d). In general, §1.861–20(d) assigns foreign gross income to the statutory and residual groupings to which the corresponding U.S. item is assigned. Section 1.861–20(d)(3)(i)(C) assigns the foreign law pass-through income that USP includes by reason of its ownership of CFC to the statutory and residual groupings by treating USP's foreign law pass-through income as foreign gross income of CFC, and by treating CFC as paying the $150x of Country A tax in CFC's U.S. taxable year within which its foreign taxable year ends (Year 1). CFC is therefore treated as including a $1,000x foreign gross royalty item and a $500x foreign gross income item of gain and paying $150x of Country A tax in Year 1. These foreign gross income items are assigned to the statutory and residual groupings to which the corresponding U.S. items are assigned under Federal income tax law. No foreign gross income is assigned to the section 245A(d) income group because neither the corresponding U.S. item of royalty income nor the corresponding U.S. item of gain is assigned to the section 245A(d) income group. Therefore, none of USP's Country A tax is allocated to the section 245A(d) income group.

(C) *Attribution of foreign income taxes to non-inclusion income.* The $150x Country A tax is described in paragraph (b)(2) of this section because USP is a United States shareholder of CFC, CFC is a reverse hybrid, and §1.861–20(d)(3)(i)(C) allocates and apportions the tax by reference to the income of CFC. Under paragraph (b)(2)(iii) of this section, the $150x Country A tax is attributable to the non-inclusion income of CFC to the extent that the foreign income taxes are allocated and apportioned to the non-inclusion income group under §1.861–20. For the reasons described in paragraph (d)(6)(ii)(B) of this section, under §1.861–20(d)(3)(i)(C) CFC is treated as including a $1,000x foreign gross royalty item and a $500x foreign gross income item of gain and paying $150x of Country A tax in Year 1. These foreign gross income items are assigned to the statutory and residual groupings to which the corresponding U.S. items are assigned under Federal income tax law. For Federal income tax purposes, the $500x item of gain and $500x of the $1,000x item of royalty income are items of non-inclusion income that are therefore assigned to the non-inclusion income group. The remaining $500x of the foreign gross royalty income item is assigned to the residual grouping. Under §1.861–20(f), $100x ($150x × $1,000x/$1,500x) of the Country A tax is apportioned to the non-inclusion income group, and $50x ($150x × $500x/$1,500x) is apportioned to the residual grouping. Under paragraph (b)(2)(iii) of this section, the $100x of Country A tax that is apportioned to the non-inclusion income group under §1.861–20(d)(3)(i)(C) is attributable to non-inclusion income of CFC.

(D) *Disallowance.* Under paragraph (a)(1)(iii) of this section, no credit under section 901 or deduction is allowed in any taxable year to USP for the $100x of Country A foreign income tax that is attributable to non-inclusion income of CFC.

(e) *Applicability date.* This section applies to taxable years of a foreign corporation that begin after December 31, 2019, and end on or after November 2, 2020, and with respect to a United States person, taxable years in which or with which such taxable years of the foreign corporation end.

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§ 1.245A(e)–1 Special rules for hybrid dividends.

(a) *Overview.* This section provides rules for hybrid dividends. Paragraph (b) of this section disallows the deduction under section 245A(a) for a hybrid dividend received by a United States shareholder from a CFC. Paragraph (c) of this section provides a rule for hybrid dividends of tiered corporations. Paragraph (d) of this section sets forth rules regarding a hybrid deduction account. Paragraph (e) of this section provides an anti-avoidance rule. Paragraph (f) of this section provides definitions. Paragraph (g) of this section illustrates the application of the rules of this section through examples. Paragraph (h) of this section provides the applicability date.

(b) *Hybrid dividends received by United States shareholders*—(1) *In general.* If a United States shareholder receives a hybrid dividend, then—

(i) The United States shareholder is not allowed a deduction under section 245A(a) for the hybrid dividend; and

(ii) The rules of section 245A(d) and §1.245A(d)–1 (disallowance of foreign tax credits and deductions) apply to the hybrid dividend. See paragraph (g)(1) of this section for an example illustrating the application of paragraph (b) of this section.

(2) *Definition of hybrid dividend.* The term *hybrid dividend* means an amount received by a United States shareholder from a CFC for which, without regard to section 245A(e) and this section as well as §1.245A–5, the United States shareholder would be allowed a deduction under section 245A(a), to the extent of the sum of the United States shareholder's hybrid deduction accounts (as described in paragraph (d) of this section) with respect to each share of stock of the CFC, determined at the close of the CFC's taxable year (or in accordance with paragraph (d)(5) of this section, as applicable). No other amount received by a United States shareholder from a CFC is a hybrid dividend for purposes of section 245A.

(3) *Special rule for certain dividends attributable to earnings of lower-tier foreign corporations.* This paragraph (b)(3) applies if a domestic corporation directly or indirectly (as determined under the principles of §1.245A–5(g)(3)(ii)) sells or exchanges stock of a foreign corporation and, pursuant to section 1248, the gain recognized on the sale or exchange is included in gross income as a dividend. In such a case, for purposes of this section—

(i) To the extent that earnings and profits of a lower-tier CFC gave rise to the dividend under section 1248(c)(2), those earnings and profits are treated as distributed as a dividend by the lower-tier CFC directly to the domestic corporation under the principles of §1.1248–1(d); and

(ii) To the extent the domestic corporation indirectly owns (within the meaning of section 958(a)(2), and determined by treating a domestic partnership as foreign) shares of stock of the lower-tier CFC, the hybrid deduction accounts with respect to those shares are treated as the domestic corporation's hybrid deduction accounts with respect to stock of the lower-tier CFC. Thus, for example, if a domestic corporation sells or exchanges all the stock of an upper-tier CFC and under this paragraph (b)(3) there is considered to be a dividend paid directly by the lower-tier CFC to the domestic corporation, then the dividend is generally a hybrid dividend to the extent of the sum of the upper-tier CFC's hybrid deduction accounts with respect to stock of the lower-tier CFC.

(4) *Ordering rule.* Amounts received by a United States shareholder from a CFC are subject to the rules of section 245A(e) and this section based on the order in which they are received. Thus, for example, if on different days during a CFC's taxable year a United States shareholder receives dividends from the CFC, then the rules of section 245A(e) and this section apply first to the dividend received on the earliest date (based on the sum of the United States shareholder's hybrid deduction accounts with respect to each share of stock of the CFC), and then to the dividend received on the next earliest date (based on the remaining sum).

(c) *Hybrid dividends of tiered corporations*—(1) *In general.* If a CFC (the *receiving CFC*) receives a tiered hybrid dividend from another CFC, and a domestic corporation is a United States shareholder with respect to both CFCs, then, notwithstanding any other provision of the Code—

(i) For purposes of section 951(a) as to the United States shareholder, the tiered hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of the receiving CFC for the taxable year of the CFC in which the tiered hybrid dividend is received;

(ii) The United States shareholder includes in gross income an amount equal to its pro rata share (determined in the same manner as under section 951(a)(2)) of the subpart F income described in paragraph (c)(1)(i) of this section; and

(iii) The rules of section 245A(d) and §1.245A(d)–1 (disallowance of foreign tax credit, including for taxes that would have been deemed paid under section 960(a) or (b), and deductions) apply to the amount included under paragraph (c)(1)(ii) of this section in the United States shareholder's gross income. See paragraph (g)(2) of this section for an example illustrating the application of paragraph (c) of this section.

(2) *Definition of tiered hybrid dividend.* The term *tiered hybrid dividend* means an amount received by a receiving CFC from another CFC to the extent that the amount would be a hybrid dividend under paragraph (b)(2) of this section if, for purposes of section 245A and the regulations in this part under section 245A (except for section 245A(e)(2) and this paragraph (c)), the receiving CFC were a domestic corporation. A tiered hybrid dividend does not include an amount described in section 959(b). No other amount received by a receiving CFC from another CFC is a tiered hybrid dividend for purposes of section 245A.

(3) *Special rule for certain dividends attributable to earnings of lower-tier foreign corporations.* This paragraph (c)(3) applies if a CFC directly or indirectly (as determined under the principles of §1.245A–5(g)(3)(ii)) sells or exchanges stock of a foreign corporation and pursuant to section 964(e)(1) the gain recognized on the sale or exchange is included in gross income as a dividend. In such a case, the rules of paragraph (b)(3) of this section apply, by treating the CFC as the domestic corporation described in paragraph (b)(3) of this section and substituting the phrase "sections 964(e)(1) and 1248(c)(2)" for the phrase "section 1248(c)(2)" in paragraph (b)(3)(i) of this section.

(4) *Interaction with rules under section 964(e).* To the extent a dividend described in section 964(e)(1) (gain on certain stock sales by CFCs treated as dividends) is a tiered hybrid dividend, the rules of section 964(e)(4) do not apply as to a domestic corporation that is a United States shareholder of both of the CFCs described in paragraph (c)(1) of this section and, therefore, such United States shareholder is not allowed a deduction under section

245A(a) for the amount included in gross income under paragraph (c)(1)(ii) of this section.

(d) *Hybrid deduction accounts*—(1) *In general.* A specified owner of a share of CFC stock must maintain a hybrid deduction account with respect to the share. The hybrid deduction account with respect to the share must reflect the amount of hybrid deductions of the CFC allocated to the share (as determined under paragraphs (d)(2) and (3) of this section), and must be maintained in accordance with the rules of paragraphs (d)(4) through (6) of this section.

(2) *Hybrid deductions*—(i) *In general.* The term *hybrid deduction* of a CFC means a deduction or other tax benefit (such as an exemption, exclusion, or credit, to the extent equivalent to a deduction) for which the requirements of paragraphs (d)(2)(i)(A) and (B) of this section are both satisfied.

(A) The deduction or other tax benefit is allowed to the CFC (or a person related to the CFC) under a relevant foreign tax law, regardless of whether the deduction or other tax benefit is used, or otherwise reduces tax, currently under the relevant foreign tax law.

(B) The deduction or other tax benefit relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC and treated as stock for U.S. tax purposes, or is a deduction allowed to the CFC with respect to equity. Examples of such a deduction or other tax benefit include an interest deduction, a dividends paid deduction, and a notional interest deduction (or similar deduction determined with respect to the CFC's equity). However, a deduction or other tax benefit relating to or resulting from a distribution by the CFC that is a dividend for purposes of the relevant foreign tax law is considered a hybrid deduction only to the extent it has the effect of causing the earnings that funded the distribution to not be included in income (determined under the principles of §1.267A–3(a)) or otherwise subject to tax under such tax law. Thus, for example, upon a distribution by a CFC that is treated as a dividend for purposes of the CFC's tax law to a shareholder of the CFC, a dividends paid deduction allowed to the CFC under its tax law (or a refund to the shareholder, including through a credit, of tax paid by the CFC on the earnings that funded the distribution) pursuant to an integration or imputation system is not a hybrid deduction of the CFC to the extent that the shareholder, if a tax resident of the CFC's country, includes the distribution in income under the CFC's tax law or, if not a tax resident of the CFC's country, is subject to withholding tax (as defined in section 901(k)(1)(B)) on the distribution under the CFC's tax law. As an additional example, upon a distribution by a CFC to a shareholder of the CFC that is a tax resident of the CFC's country, a dividends received deduction allowed to the shareholder under the tax law of such foreign country pursuant to a regime intended to relieve double-taxation within the group is not a hybrid deduction of the CFC (though if the CFC were also allowed a deduction or other tax benefit for the distribution under such tax, such deduction or other tax benefit would be a hybrid deduction of the CFC). See paragraphs (g)(1) and (2) of this section for examples illustrating the application of paragraph (d) of this section.

(ii) *Coordination with foreign disallowance rules.* The following special rules apply for purposes of determining whether a deduction or other tax benefit is allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law:

(A) Whether the deduction or other tax benefit is allowed is determined without regard to a rule under the relevant foreign tax law that disallows or suspends deductions if a certain ratio or percentage is exceeded (for example, a thin capitalization rule that disallows interest deductions if debt to equity exceeds a certain ratio, or a rule similar to section 163(j) that disallows or suspends interest deductions if interest exceeds a certain percentage of income).

(B) Except as provided in this paragraph (d)(2)(ii)(B), whether the deduction or other tax benefit is allowed is determined without regard to hybrid mismatch rules, if any, under the relevant foreign tax law that may disallow such deduction or other tax benefit. However, whether the deduction or other tax benefit is allowed is determined with regard to hybrid mismatch rules under the relevant foreign tax law if the amount giving rise to the deduction or other tax benefit neither gives rise to a dividend for U.S. tax purposes nor, based on all the facts and circumstances, is reasonably expected to give rise to a dividend for U.S. tax purposes that will be paid within 12 months from the end of the taxable period for which the deduction or other tax benefit would be allowed but for the hybrid mismatch rules. For purposes of this paragraph (d)(2)(ii)(B), the term hybrid mismatch rules has the meaning provided in §1.267A–5(b)(10).

(iii) *Anti-duplication rule.* A deduction or other tax benefit allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law for an amount paid, accrued, or distributed with respect to an instrument issued by the CFC is not a hybrid deduction to the extent that treating it as a hybrid deduction would have the effect of duplicating a hybrid deduction that is a deduction or other tax benefit allowed under such tax law for an amount paid, accrued, or distributed with respect to an instrument that is issued by a CFC at a higher tier and that has terms substantially similar to the terms of the first instrument. For example, if an upper tier CFC issues to a corporate United States shareholder a hybrid instrument (the ''upper tier instrument''), a lower tier CFC issues to the upper tier CFC a hybrid instrument that has terms substantially similar to the terms of the upper tier instrument (the ''mirror instrument''), the CFCs are tax residents of the same foreign country, and the upper tier CFC includes in income under its tax law (as determined under the principles of §1.267A–3(a)) amounts accrued with respect to the mirror instrument, then a deduction allowed to the lower tier CFC under such foreign tax law for an amount accrued pursuant to the mirror instrument is not a hybrid deduction (but a deduction allowed to the upper tier CFC under the foreign tax law for an amount accrued with respect to the upper tier instrument is a hybrid deduction).

(iv) *Application limited to items allowed in taxable years ending on or after December 20, 2018; special rule for deductions with respect to equity.* A deduction or other tax benefit, other than a deduction with respect to equity, allowed to a CFC (or a person related to the CFC) under a relevant foreign tax law is taken into account for purposes of this section only if it was allowed with respect to a taxable year under the relevant foreign tax law ending on or after December 20, 2018. A deduction with respect to equity allowed to a CFC under a relevant foreign tax law is taken into account for purposes of this section only if it was allowed with respect to a taxable year under the relevant foreign tax law beginning on or after December 20, 2018.

(3) *Allocating hybrid deductions to shares.* A hybrid deduction is allocated to a share of stock of a CFC to the extent that the hybrid deduction (or amount equivalent to a deduction) relates to an amount paid, accrued, or distributed by the CFC with respect to the share. However, in the case of a hybrid deduction that is a deduction with respect to equity (such as a notional interest deduction), the deduction is allocated to a share of stock of a CFC based on the product of—

(i) The amount of the deduction allowed for all of the equity of the CFC; and

(ii) A fraction, the numerator of which is the value of the share and the denominator of which is the value of all of the stock of the CFC.

(4) *Maintenance of hybrid deduction accounts*—(i) *In general.* A specified owner's hybrid deduction account with respect to a share of stock of a CFC is, as of the close of the taxable year of the CFC, adjusted pursuant to the following rules.

(A) First, the account is increased by the amount of hybrid deductions of the CFC allocated to the share for the taxable year.

(B) Second, the account is decreased (but not below zero) pursuant to the rules of paragraphs (d)(4)(i)(B)(*1*) through (*3*) of this section, in the order set forth in this paragraph (d)(4)(i)(B).

(*1*) *Adjusted subpart F inclusions*—(*i*) *In general.* Subject to the limitation in paragraph (d)(4)(i)(B)(*1*)(*ii*) of this section, the account is reduced by an adjusted subpart F inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(*ii*) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(*1*)(*i*) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the sum of the items of gross income of the CFC that give rise to subpart F income (determined without regard to an amount treated as subpart F income by reason of section 964(e)(4)(A)(i), to the extent that a deduction under section 245A(a) is allowed for a portion of the amount included under section 964(e)(4)(A)(ii) in the gross income of a domestic corporation) of the CFC for the taxable year and the denominator of which is the sum of all the items of gross income of the CFC for the taxable year.

(*iii*) *Special rule allocating otherwise unused adjusted subpart F inclusions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(*1*)(*iii*) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(*1*)(*i*) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(*2*) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(*1*)(*i*) of this section but for the limitation in paragraph (d)(4)(i)(B)(*1*)(*ii*) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *unused reduction amount*, and the accounts that would have been reduced by the unused reduction amount, the *unused reduction amount accounts*). When this paragraph (d)(4)(i)(B)(*1*)(*iii*) applies, the specified owner's hybrid deduction accounts other than the unused reduction amount accounts (if any) are ratably reduced by the lesser of the unused reduction amount and the difference of the following two amounts: The hybrid deductions of the CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(*1*)(*ii*) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(*1*)(*i*) of this section with respect to the specified owner's shares of stock of the CFC.

(*2*) *Adjusted GILTI inclusions*—(*i*) *In general.* Subject to the limitation in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section, the account is reduced by an adjusted GILTI inclusion with respect to the share for the taxable year, as determined pursuant to the rules of paragraph (d)(4)(ii) of this section.

(*ii*) *Limitation.* The reduction pursuant to paragraph (d)(4)(i)(B)(*2*)(*i*) of this section cannot exceed the hybrid deductions of the CFC allocated to the share for the taxable year multiplied by a fraction, the numerator of which is the sum of the items of gross tested income of the CFC for the taxable year and the denominator of which is the sum of all the items of gross income of the CFC for the taxable year.

(*iii*) *Special rule allocating otherwise unused adjusted GILTI inclusions across accounts in certain cases.* This paragraph (d)(4)(i)(B)(*2*)(*iii*) applies after each of the specified owner's hybrid deduction accounts with respect to its shares of stock of the CFC are adjusted pursuant to paragraph (d)(4)(i)(B)(*2*)(*i*) of this section but before the accounts are adjusted pursuant to paragraph (d)(4)(i)(B)(*3*) of this section, to the extent that one or more of the hybrid deduction accounts would have been reduced by an amount pursuant to paragraph (d)(4)(i)(B)(*2*)(*i*) of this section but for the limitation in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section (the aggregate of the amounts that would have been reduced but for the limitation, the *unused reduction amount*, and the accounts that would have been reduced by the unused reduction amount, the *unused reduction amount accounts*). When this paragraph (d)(4)(i)(B)(*2*)(*iii*) applies, the specified owner's hybrid deduction accounts other than the unused reduction amount accounts (if any) are ratably reduced by the lesser of the unused reduction amount and the difference of the following two amounts: The hybrid deductions of the

CFC allocated to the specified owner's shares of stock of the CFC for the taxable year multiplied by the fraction described in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section; and the reductions pursuant to paragraph (d)(4)(i)(B)(*2*)(*i*) of this section with respect to the specified owner's shares of stock of the CFC. *See* paragraph (g)(1)(v)(C) of this section for an illustration of the application of this paragraph (d)(4)(i)(B)(*2*)(*iii*).

(*3*) *Certain section 956 inclusions*. The account is reduced by an amount included in the gross income of a domestic corporation under sections 951(a)(1)(B) and 956 with respect to the share for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent so included by reason of the application of section 245A(e) and this section to the hypothetical distribution described in §1.956–1(a)(2).

(C) Third, the account is decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the taxable year. If the specified owner has more than one hybrid deduction account with respect to its stock of the CFC, then a pro rata amount in each hybrid deduction account is considered to have given rise to the hybrid dividend or tiered hybrid dividend, based on the amounts in the accounts before applying this paragraph (d)(4)(i)(C).

(ii) *Rules regarding adjusted subpart F and GILTI inclusions*. (A) The term *adjusted subpart F inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's pro rata share of the CFC's subpart F income included in gross income under section 951(a)(1)(A) (determined without regard to an amount included in gross income by the domestic corporation by reason of section 964(e)(4)(A)(ii), to the extent a deduction under section 245A(a) is allowed for the amount) for the taxable year of the domestic corporation in which or with which the CFC's taxable year ends, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951–1(b) and (e)), adjusted (but not below zero) by—

(*1*) Adding to the amount the associated foreign income taxes with respect to the amount; and

(*2*) Subtracting from such sum the quotient of the associated foreign income taxes divided by the percentage described in section 11(b).

(B) The term *adjusted GILTI inclusion* means, with respect to a share of stock of a CFC for a taxable year of the CFC, a domestic corporation's GILTI inclusion amount (within the meaning of §1.951A–1(c)(1)) for the U.S. shareholder inclusion year (within the meaning of §1.951A–1(f)(7)), to the extent attributable to the share (as determined under paragraph (d)(4)(ii)(C) of this section), adjusted (but not below zero) by—

(*1*) Adding to the amount the associated foreign income taxes with respect to the amount;

(*2*) Multiplying such sum by the difference of 100 percent and the section 250(a)(1)(B)(i) deduction percentage; and

(*3*) Subtracting from such product the quotient of 80 percent of the associated foreign income taxes divided by the percentage described in section 11(b).

(C) A domestic corporation's GILTI inclusion amount for a U.S. shareholder inclusion year is attributable to a share of stock of the CFC based on a fraction—

(*1*) The numerator of which is the domestic corporation's pro rata share of the tested income of the CFC for the U.S. shareholder inclusion year, to the extent attributable to the share (as determined under the principles of §1.951A–1(d)(2)); and

(*2*) The denominator of which is the aggregate of the domestic corporation's pro rata share of the tested income of each tested income CFC (as defined in §1.951A–2(b)(1)) for the U.S. shareholder inclusion year.

(D) The term *associated foreign income taxes* means—

(*1*) With respect to a domestic corporation's pro rata share of the subpart F income of the CFC included in gross income under section 951(a)(1)(A) and attributable to a share of stock of a CFC for a taxable year of the CFC, current year tax (as described in §1.960–1(b)(4)) allocated and apportioned under §1.960–1(d)(3)(ii) to the subpart F income groups (as described in §1.960–1(b)(30)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(E) of this section; and

(*2*) With respect to a domestic corporation's GILTI inclusion amount under section 951A attributable to a share of stock of a CFC for a taxable year of the CFC, the product of—

(*i*) Current year tax (as described in §1.960–1(b)(4)) allocated and apportioned under §1.960–1(d)(3)(ii) to the tested income groups (as described in §1.960–1(b)(33)) of the CFC for the taxable year, to the extent allocated to the share under paragraph (d)(4)(ii)(F) of this section;

(*ii*) The domestic corporation's inclusion percentage (as described in §1.960–2(c)(2)); and

(*iii*) The section 904 limitation fraction with respect to the domestic corporation for the U.S. shareholder inclusion year.

(E) Current year tax allocated and apportioned to a subpart F income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(*1*) The numerator of which is the domestic corporation's pro rata share of the subpart F income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles of section 951(a)(2) and §1.951–1(b) and (e)); and

(*2*) The denominator of which is the subpart F income of the CFC for the taxable year.

(F) Current year tax allocated and apportioned to a tested income group of a CFC for a taxable year is allocated to a share of stock of the CFC by multiplying the foreign income tax by a fraction—

(*1*) The numerator of which is the domestic corporation's pro rata share of tested income of the CFC for the taxable year, to the extent attributable to the share (as determined under the principles §1.951A–1(d)(2)); and

(*2*) The denominator of which is the tested income of the CFC for the taxable year.

(G) The term *section 904 limitation fraction* means, with respect to a domestic corporation for a U.S. shareholder inclusion year, a fraction—

(*1*) The numerator of which is the amount of foreign tax credits for the U.S. shareholder inclusion year that, by reason of sections 901 and 960(d) and taking into account section 904, the domestic corporation is allowed for the separate category set forth in section 904(d)(1)(A) (amounts includible in gross income under section 951A); and

(*2*) The denominator of which is the amount of foreign tax credits for the U.S. shareholder inclusion year that, by reason of sections 901 and 960(d) and without regard to section 904, the domestic corporation would be allowed for the separate category set forth in section 904(d)(1)(A) (amounts includible in gross income under section 951A).

(H) The term *section 250(a)(1)(B)(i) deduction percentage* means, with respect to a domestic corporation for a U.S. shareholder inclusion year, a fraction—

(*1*) The numerator of which is the amount of the deduction under section 250 allowed to the domestic corporation for the U.S. shareholder inclusion year by reason of section 250(a)(1)(B)(i) (taking into account section 250(a)(2)(B)); and

(*2*) The denominator of which is the domestic corporation's GILTI inclusion amount for the U.S. shareholder inclusion year.

(iii) *Acquisition of account and certain other adjustments*—(A) *In general*. The following rules apply when a person (the *acquirer*) directly or indirectly through a partnership, trust, or estate acquires a share of stock of a CFC from another person (the *transferor*).

(*1*) In the case of an acquirer that is a specified owner of the share immediately after the acquisition, the transferor's hybrid deduction account, if any, with respect to the share becomes the hybrid deduction account of the acquirer.

(*2*) In the case of an acquirer that is not a specified owner of the share immediately after the acquisition, the transferor's hybrid deduction account, if any, is eliminated and accordingly is not thereafter taken into account by any person.

(B) *Additional rules*. The following rules apply in addition to the rules of paragraph (d)(4)(iii)(A) of this section.

(*1*) *Certain section 354 or 356 exchanges*. The following rules apply when a shareholder of a CFC (the CFC, the *target CFC;* the shareholder, the *exchanging shareholder*) exchanges stock of the target CFC for stock of another CFC (the *acquiring CFC*) pursuant to an exchange described in section 354 or 356 that occurs in connection with a transaction described in section 381(a)(2) in which the target CFC is the transferor corporation.

(*i*) In the case of an exchanging shareholder that is a specified owner of one or more shares of stock of the acquiring CFC immediately after the exchange, the exchanging shareholder's hybrid deduction accounts with respect to the shares of stock of the target CFC that it exchanges are attributed to the shares of stock of the acquiring CFC that it receives in the exchange.

(*ii*) In the case of an exchanging shareholder that is not a specified owner of one or more shares of stock of the acquiring CFC immediately after the exchange, the exchanging shareholder's hybrid deduction accounts with respect to its shares of stock of the target CFC are eliminated and accordingly are not thereafter taken into account by any person.

(*2*) *Section 332 liquidations*. If a CFC is a distributor corporation in a transaction described in section 381(a)(1) (the *distributor CFC*) in which a controlled foreign corporation is the acquiring corporation (the *distributee CFC*), then each hybrid deduction account with respect to a share of stock of the distributee CFC is increased pro rata by the sum of the hybrid deduction accounts with respect to shares of stock of the distributor CFC.

(*3*) *Recapitalizations*. If a shareholder of a CFC exchanges stock of the CFC pursuant to a reorganization described in section 368(a)(1)(E) or a transaction to which section 1036 applies, then the shareholder's hybrid deduction accounts with respect to the stock of the CFC that it exchanges are attributed to the shares of stock of the CFC that it receives in the exchange.

(*4*) *Certain distributions involving section 355 or 356*. In the case of a transaction involving a distribution under section 355 (or so much of section 356 as it relates to section 355) by a CFC (the *distributing CFC*) of stock of another CFC (the *controlled CFC*), the balance of the hybrid deduction accounts with respect to stock of the distributing CFC is attributed to stock of the controlled CFC in a manner similar to how earnings and profits of the distributing CFC and controlled CFC are adjusted. To the extent the balance of the hybrid deduction accounts with respect to stock of the distributing CFC is not so attributed to stock of the controlled CFC, such balance remains as the balance of the hybrid deduction accounts with respect to stock of the distributing CFC.

(*5*) *Effect of section 338(g) election*—(*i*) *In general*. If an election under section 338(g) is made with respect to a qualified stock purchase (as described in section 338(d)(3)) of stock of a CFC, then a hybrid deduction account with respect to a share of stock of the old target is not treated as (or attributed to) a hybrid deduction account with respect to a share of stock of the new target. Accordingly, immediately after the deemed asset sale described in §1.338–1, the balance of a hybrid deduction account with respect to a share of stock of the new target is zero; the account must then be maintained in accordance with the rules of paragraph (d) of this section.

(*ii*) *Special rule regarding carryover FT stock*. Paragraph (d)(4)(iii)(B)(*5*)(*i*) of this section does not apply as to a hybrid deduction account with respect to a share of carryover FT stock (as described in §1.338–9(b)(3)(i)). A hybrid deduction account with respect to a share of carryover FT stock is attributed to the corresponding share of stock of the new target.

(5) *Determinations and adjustments made during year of transfer in certain cases*. This paragraph (d)(5) applies if on a date other than the date that is the last day of the CFC's taxable year a United States shareholder of the CFC or an upper-tier CFC with respect to the CFC directly or indirectly (as determined under the principles of §1.245A–5(g)(3)(ii)) transfers a share of stock of the CFC, and, during the taxable year, but on or before the transfer date, the United States shareholder or upper-tier CFC receives an amount from the CFC that is subject to the

rules of section 245A(e) and this section. In such a case, the following rules apply:

(i) As to the United States shareholder or upper-tier CFC and the United States shareholder's or upper-tier CFC's hybrid deduction accounts with respect to each share of stock of the CFC (regardless of whether such share is transferred), the determinations and adjustments under this section that would otherwise be made at the close of the CFC's taxable year are made at the close of the date of the transfer. When making these determinations and adjustments at the close of the date of the transfer, each hybrid deduction account described in the previous sentence is pursuant to paragraph (d)(4)(ii)(A) of this section increased by a ratable portion (based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year) of the hybrid deductions of the CFC allocated to the share for the taxable year, and pursuant to paragraph (d)(4)(ii)(C) of this section decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the portion of the taxable year up to and including the transfer date. Thus, for example, if a United States shareholder of a CFC exchanges stock of the CFC in an exchange described in §1.367(b)–4(b)(1)(i) and is required to include in income as a deemed dividend the section 1248 amount attributable to the stock exchanged, then: As of the close of the date of the exchange, each of the United States shareholder's hybrid deductions accounts with respect to a share of stock of the CFC is increased by a ratable portion of the hybrid deductions of the CFC allocated to the share for the taxable year (based on the number of days in the taxable year within the pre-transfer period to the total number of days in the taxable year); the deemed dividend is a hybrid dividend to the extent of the sum of the United States shareholder's hybrid deduction accounts with respect to each share of stock of the CFC; and, as the close of the date of the exchange, each of the accounts is decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend during the portion of the taxable year up to and including the date of the exchange.

(ii) As to a hybrid deduction account described in paragraph (d)(5)(i) of this section, the adjustments to the account as of the close of the taxable year of the CFC must take into account the adjustments, if any, occurring with respect to the account pursuant to paragraph (d)(5)(i) of this section. Thus, for example, if an acquisition of a share of stock of a CFC occurs on a date other than the date that is the last day of the CFC's taxable year and pursuant to paragraph (d)(4)(iii)(A)(*1*) of this section the acquirer succeeds to the transferor's hybrid deduction account with respect to the share, then, as of the close of the taxable year of the CFC, the account is increased by a ratable portion of the hybrid deductions of the CFC allocated to the share for the taxable year (based on the number of days in the taxable year within the post-transfer period to the total number of days in the taxable year), and, decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during the portion of the taxable year following the transfer date.

(6) *Effects of CFC functional currency*—(i) *Maintenance of the hybrid deduction account.* A hybrid deduction account with respect to a share of CFC stock must be maintained in the functional currency (within the meaning of section 985) of the CFC. Thus, for example, the amount of a hybrid deduction and the adjustments described in paragraphs (d)(4)(i)(A) and (B) of this section are determined based on the functional currency of the CFC. In addition, for purposes of this section, the amount of a deduction or other tax benefit allowed to a CFC (or a person related to the CFC) is determined taking into account foreign currency gain or loss recognized with respect to such deduction or other tax benefit under a provision of foreign tax law comparable to section 988 (treatment of certain foreign currency transactions).

(ii) *Determination of amount of hybrid dividend.* This paragraph (d)(6)(ii) applies if a CFC's functional currency is other than the functional currency of a

United States shareholder or upper-tier CFC that receives an amount from the CFC that is subject to the rules of section 245A(e) and this section. In such a case, the sum of the United States shareholder's or upper-tier CFC's hybrid deduction accounts with respect to each share of stock of the CFC is, for purposes of determining the extent that a dividend is a hybrid dividend or tiered hybrid dividend, translated into the functional currency of the United States shareholder or upper-tier CFC based on the spot rate (within the meaning of §1.988–1(d)) as of the date of the dividend.

(e) *Anti-avoidance rule.* Appropriate adjustments are made pursuant to this section, including adjustments that would disregard the transaction or arrangement, if a transaction or arrangement is undertaken with a principal purpose of avoiding the purposes of section 245A(e) and this section. For example, if a specified owner of a share of CFC stock transfers the share to another person, and a principal purpose of the transfer is to shift the hybrid deduction account with respect to the share to the other person or to cause the hybrid deduction account to be eliminated, then for purposes of this section the shifting or elimination of the hybrid deduction account is disregarded as to the transferor. As another example, if a transaction or arrangement is undertaken to affirmatively fail to satisfy the holding period requirement under section 246(c)(5) with a principal purpose of avoiding the tiered hybrid dividend rules described in paragraph (c) of this section, the transaction or arrangement is disregarded for purposes of this section. This paragraph (e) will not apply, however, to disregard (or make other adjustments with respect to) a transaction pursuant to which an instrument or arrangement that gives rise to hybrid deductions is eliminated or otherwise converted into another instrument or arrangement that does not give rise to hybrid deductions.

(f) *Definitions.* The following definitions apply for purposes of this section.

(1) The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(2) The term *domestic corporation* means an entity classified as a domestic corporation under section 7701(a)(3) and (4) or otherwise treated as a domestic corporation by the Internal Revenue Code. However, for purposes of this section, a domestic corporation does not include a regulated investment company (as described in section 851), a real estate investment trust (as described in section 856), or an S corporation (as described in section 1361).

(3) The term *person* has the meaning provided in section 7701(a)(1).

(4) The term *related* has the meaning provided in this paragraph (f)(4). A person is related to a CFC if the person is a related person within the meaning of section 954(d)(3). *See also* §1.954–1(f)(2)(iv)(B)(*1*) (neither section 318(a)(3), nor §1.958–2(d) or the principles thereof, applies to attribute stock or other interests).

(5) The term *relevant foreign tax law* means, with respect to a CFC, any regime of any foreign country or possession of the United States that imposes an income, war profits, or excess profits tax with respect to income of the CFC, other than a foreign anti-deferral regime under which a person that owns an interest in the CFC is liable to tax. If a foreign country has an income tax treaty with the United States that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a foreign country. Thus, the term includes any regime of a foreign country or possession of the United States that imposes income, war profits, or excess profits tax under which—

(i) The CFC is liable to tax as a resident;

(ii) The CFC has a branch that gives rise to a taxable presence in the foreign country or possession of the United States; or

(iii) A person related to the CFC is liable to tax as a resident, provided that under such person's tax law the person is allowed a deduction for amounts paid or accrued by the CFC (because the CFC is fiscally transparent under the person's tax law).

(6) The term *specified owner* means, with respect to a share of stock of a

CFC, a person for which the requirements of paragraphs (f)(6)(i) and (ii) of this section are satisfied.

(i) The person is a domestic corporation that is a United States shareholder of the CFC, or is an upper-tier CFC that would be a United States shareholder of the CFC were the upper-tier CFC a domestic corporation (provided that, for purposes of sections 951 and 951A, a domestic corporation that is a United States shareholder of the upper-tier CFC owns (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) one or more shares of stock of the upper-tier CFC).

(ii) The person owns the share directly or indirectly through a partnership, trust, or estate. Thus, for example, if a domestic corporation directly owns all the shares of stock of an upper-tier CFC and the upper-tier CFC directly owns all the shares of stock of another CFC, the domestic corporation is the specified owner with respect to each share of stock of the upper-tier CFC and the upper-tier CFC is the specified owner with respect to each share of stock of the other CFC.

(7) The term *United States shareholder* has the meaning provided in section 951(b).

(g) *Examples.* This paragraph (g) provides examples that illustrate the application of this section. For purposes of the examples in this paragraph (g), unless otherwise indicated, the following facts are presumed. US1 is a domestic corporation. FX and FZ are CFCs formed at the beginning of year 1, and the functional currency (within the meaning of section 985) of each of FX and FZ is the dollar. FX is a tax resident of Country X and FZ is a tax resident of Country Z. US1 is a United States shareholder with respect to FX and FZ. No distributed amounts are attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a). All instruments are treated as stock for U.S. tax purposes. Only the tax law of the United States contains hybrid mismatch rules. No amounts are included in the gross income of US1 under section 951(a)(1)(A), 951A(a), or 951(a)(1)(B) and section 956.

(1) *Example 1. Hybrid dividend resulting from hybrid instrument*—(i) *Facts.* US1 holds both shares of stock of FX, which have an equal value. One share is treated as indebtedness for Country X tax purposes (''Share A''), and the other is treated as equity for Country X tax purposes (''Share B''). During year 1, under Country X tax law, FX accrues $80x of interest to US1 with respect to Share A and is allowed a deduction for the amount (the ''Hybrid Instrument Deduction''). During year 2, FX distributes $30x to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the $30x distributions is treated as a dividend for which, without regard to section 245A(e) and this section as well as § 1.245A–5, US1 would be allowed a deduction under section 245A(a). For Country X tax purposes, the $30x distribution with respect to Share A represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the $30x distribution with respect to Share B is treated as a dividend (for which no deduction is allowed).

(ii) *Analysis.* The entire $30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 ($80x) is at least equal to the amount of the dividends ($60x). *See* paragraph (b)(2) of this section. This is the case for the $30x dividend with respect to Share B even though there are no hybrid deductions allocated to Share B. *See* paragraph (b)(2) of this section. As a result, US1 is not allowed a deduction under section 245A(a) for the entire $60x of hybrid dividends and the rules of section 245A(d) and § 1.245A(d)–1 (disallowance of foreign tax credits and deductions) apply. *See* paragraph (b)(1) of this section. Paragraphs (g)(1)(ii)(A) through (D) of this section describe the determinations under this section.

(A) At the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are $80x and $0, respectively, calculated as follows.

(*1*) The $80x Hybrid Instrument Deduction allowed to FX under Country X tax law (a relevant foreign tax law) is a hybrid deduction of FX, because the deduction is allowed to FX and relates to or results from an amount accrued with respect to an instrument issued by FX and treated as stock for U.S. tax purposes. *See* paragraph (d)(2)(i) of this section. Thus, FX's hybrid deductions for year 1 are $80x.

(*2*) The entire $80x Hybrid Instrument Deduction is allocated to Share A, because the deduction was accrued with respect to Share A. *See* paragraph (d)(3) of this section. As there are no additional hybrid deductions of FX for year 1, there are no additional hybrid deductions to allocate to either Share A or Share B. Thus, there are no hybrid deductions allocated to Share B.

(*3*) At the end of year 1, US1's hybrid deduction account with respect to Share A is increased by $80x (the amount of hybrid deductions allocated to Share A). *See* paragraph (d)(4)(i)(A) of this section. Because FX did not pay any dividends with respect to either Share A or Share B during year 1 (and therefore did not pay any hybrid dividends or tiered hybrid dividends), no further adjustments are made. *See* paragraph (d)(4)(i)(C) of this section. Therefore, at the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are $80x and $0, respectively.

(B) At the end of year 2, and before the adjustments described in paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction accounts with respect to Share A and Share B remain $80x and $0, respectively. This is because there are no hybrid deductions of FX for year 2. *See* paragraph (d)(4)(i)(A) of this section.

(C) Because at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section) the sum of US1's hybrid deduction accounts with respect to Share A and Share B ($80x, calculated as $80x plus $0) is at least equal to the aggregate $60x of year 2 dividends, the entire $60x dividend is a hybrid dividend. *See* paragraph (b)(2) of this section.

(D) At the end of year 2, US1's hybrid deduction account with respect to Share A is decreased by $60x, the amount of the hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. *See* paragraph (d)(4)(i)(C) of this section. Because there are no hybrid deductions in the hybrid deduction account with respect to Share B, no adjustments with respect to that account are made under paragraph (d)(4)(i)(C) of this section. Therefore, at the end of year 2 and taking into account the adjustments under paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction account with respect to Share A is $20x ($80x less $60x) and with respect to Share B is $0.

(iii) *Alternative facts—notional interest deductions*. The facts are the same as in paragraph (g)(1)(i) of this section, except that for each of year 1 and year 2 FX is allowed $10x of notional interest deductions with respect to its equity, Share B, under Country X tax law (the ''NIDs''). In addition, during year 2, FX distributes $47.5x (rather than $30x) to US1 with respect to each of Share A and Share B. For U.S. tax purposes, each of the $47.5x distributions is treated as a dividend for which, without regard to section 245A(e) and this section as well as §1.245A–5, US1 would be allowed a deduction under section 245A(a). For Country X tax purposes, the $47.5x distribution with respect to Share A represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the $47.5x distribution with respect to Share B is treated as a dividend (for which no deduction is allowed). The entire $47.5x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 ($80x plus $20x, or $100x) is at least equal to the amount of the dividends ($95x). *See* paragraph (b)(2) of this section. As a result, US1 is not allowed a deduction under section 245A(a) for the $95x hybrid dividend and the rules of section 245A(d) and §1.245A(d)–1 (disallowance of foreign tax credits and deductions) apply. *See* paragraph (b)(1) of this section. Paragraphs (g)(1)(iii)(A) through (D) of this section describe the determinations under this section.

(A) The $10x of NIDs allowed to FX under Country X tax law in year 1 are hybrid deductions of FX for year 1. *See* paragraph (d)(2)(i) of this section. The

$10x of NIDs is allocated equally to each of Share A and Share B, because the hybrid deduction is with respect to equity and the shares have an equal value. *See* paragraph (d)(3) of this section. Thus, $5x of the NIDs is allocated to each of Share A and Share B for year 1. For the reasons described in paragraph (g)(1)(ii)(A)(*2*) of this section, the entire $80x Hybrid Instrument Deduction is allocated to Share A. Therefore, at the end of year 1, US1's hybrid deduction accounts with respect to Share A and Share B are $85x and $5x, respectively.

(B) Similarly, the $10x of NIDs allowed to FX under Country X tax law in year 2 are hybrid deductions of FX for year 2, and $5x of the NIDs is allocated to each of Share A and Share B for year 2. *See* paragraphs (d)(2)(i) and (d)(3) of this section. Thus, at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section), US1's hybrid deduction account with respect to Share A is $90x ($85x plus $5x) and with respect to Share B is $10x ($5x plus $5x). *See* paragraph (d)(4)(i) of this section.

(C) Because at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section) the sum of US1's hybrid deduction accounts with respect to Share A and Share B ($100x, calculated as $90x plus $10x) is at least equal to the aggregate $95x of year 2 dividends, the entire $95x of dividends are hybrid dividends. *See* paragraph (b)(2) of this section.

(D) At the end of year 2, US1's hybrid deduction accounts with respect to Share A and Share B are decreased by the amount of hybrid deductions in the accounts that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. *See* paragraph (d)(4)(i)(C) of this section. A total of $95x of hybrid deductions in the accounts gave rise to a hybrid dividend during year 2. For the hybrid deduction account with respect to Share A, $85.5x in the account is considered to have given rise to a hybrid deduction (calculated as $95x multiplied by $90x/$100x). *See* paragraph (d)(4)(i)(C) of this section. For the hybrid deduction account with respect to Share B, $9.5x in the account is considered to have given rise to a hybrid deduction (calculated as $95x multiplied by $10x/$100x). *See* paragraph (d)(4)(i)(C) of this section. Thus, following these adjustments, at the end of year 2, US1's hybrid deduction account with respect to Share A is $4.5x ($90x less $85.5x) and with respect to Share B is $0.5x ($10x less $9.5x).

(iv) *Alternative facts—deduction in branch country*—(A) *Facts.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for Country X tax purposes Share A is treated as equity (and thus the Hybrid Instrument Deduction does not exist, and under Country X tax law FX is not allowed a deduction for the $30x distributed in year 2 with respect to Share A). However, FX has a branch in Country Z that gives rise to a taxable presence under Country Z tax law, and for Country Z tax purposes Share A is treated as indebtedness and Share B is treated as equity. Also, during year 1, for Country Z tax purposes, FX accrues $80x of interest to US1 with respect to Share A and is allowed an $80x interest deduction with respect to its Country Z branch income. Moreover, for Country Z tax purposes, the $30x distribution with respect to Share A in year 2 represents a payment of interest for which a deduction was already allowed (and thus FX is not allowed an additional deduction for the amount), and the $30x distribution with respect to Share B in year 2 is treated as a dividend (for which no deduction is allowed).

(B) *Analysis.* The $80x interest deduction allowed to FX under Country Z tax law (a relevant foreign tax law) with respect to its Country Z branch income is a hybrid deduction of FX for year 1. *See* paragraphs (d)(2)(i) and (f)(5) of this section. For reasons similar to those discussed in paragraph (g)(1)(ii) of this section, at the end of year 2 (and before the adjustments described in paragraph (d)(4)(i)(C) of this section), US1's hybrid deduction accounts with respect to Share A and Share B are $80x and $0, respectively, and the sum of the accounts is $80x. Accordingly, the entire $60x of the year 2 dividend is a hybrid dividend. *See* paragraph (b)(2) of this section. Further, for the reasons described in paragraph (g)(1)(ii)(D) of this section, at the end of year 2 and taking into account the adjustments under paragraph (d)(4)(i)(C) of this section, US1's hybrid deduction account with respect to Share A is $20x ($80x less $60x) and with respect to Share B is $0.

(v) *Alternative facts—account reduced by adjusted GILTI inclusion.* The facts are the same as in paragraph (g)(1)(i) of this section, except that for taxable year 1 FX has $130x of gross tested income and $10.5x of current year tax (as described in §1.960–1(b)(4)) that is allocated and apportioned under §1.960–1(d)(3)(ii) to the tested income groups of FX. US1's ability to credit the $10.5x of current year tax is not limited under section 904(a). In addition, FX has $119.5x of tested income ($130x of gross tested income, less the $10.5x of current year tax deductions properly allocable to the gross tested income). Further, of US1's pro rata share of the tested income ($119.5x), $80x is attributable to Share A and $39.5x is attributable to Share B (as determined under the principles of §1.951A–1(d)(2)). Moreover, US1's net deemed tangible income return (as defined in §1.951A–1(c)(3)) for taxable year 1 is $71.7x, and US1 does not own any stock of a CFC other than its stock of FX. Thus, US1's GILTI inclusion amount (within the meaning of §1.951A–1(c)(1)) for taxable year 1, the U.S. shareholder inclusion year, is $47.8x (net CFC tested income of $119.5x, less net deemed tangible income return of $71.7x) and US1's inclusion percentage (as described in §1.960–2(c)(2)) is 40 ($47.8x/$119.5x). The deduction allowed to US1 under section 250 by reason of section 250(a)(1)(B)(i) is not limited as a result of section 250(a)(2)(B). At the end of year 1, US1's hybrid deduction account with respect to Share A is: First, increased by $80x (the amount of hybrid deductions allocated to Share A); and second, decreased by $10x (the sum of the adjusted GILTI inclusion with respect to Share A, and the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A) to $70x. *See* paragraphs (d)(4)(i)(A) and (B) of this section. In year 2, the entire $30x of each dividend received by US1 from FX during year 2 is a hybrid dividend, because the sum of US1's hybrid deduction accounts with respect to each of its shares of FX stock at the end of year 2 ($70x) is at least equal to the amount of the dividends ($60x). *See* paragraph (b)(2) of this section. At the end of year 2, US1's hybrid deduction account with respect to Share A is decreased by $60x (the amount of the hybrid deductions in the account that give rise to a hybrid dividend or tiered hybrid dividend during year 2) to $10x. *See* paragraph (d)(4)(i)(C) of this section. Paragraphs (g)(1)(v)(A) through (C) of this section describe the computations pursuant to paragraph (d)(4)(i)(B)(*2*) of this section.

(A) To determine the adjusted GILTI inclusion with respect to Share A for taxable year 1, it must be determined to what extent US1's $47.8x GILTI inclusion amount is attributable to Share A. *See* paragraph (d)(4)(ii)(B) of this section. Here, $32x of the inclusion is attributable to Share A, calculated as $47.8x multiplied by a fraction, the numerator of which is $80x (US1's pro rata share of the tested income of FX attributable to Share A) and denominator of which is $119.5x (US1's pro rata share of the tested income of FX, its only CFC). *See* paragraph (d)(4)(ii)(C) of this section. Next, the associated foreign income taxes with respect to the $32x GILTI inclusion amount attributable to Share A must be determined. *See* paragraphs (d)(4)(ii)(B) and (D) of this section. Such associated foreign income taxes are $2.8x, calculated as $10.5x (the current year tax allocated and apportioned to the tested income groups of FX) multiplied by a fraction, the numerator of which is $80x (US1's pro rata share of the tested income of FX attributable to Share A) and the denominator of which is $119.5x (the tested income of FX), multiplied by 40% (US1's inclusion percentage), multiplied by 1 (the section 904 limitation fraction with respect to US1's GILTI inclusion amount). *See* paragraphs (d)(4)(ii)(D), (F), and (G) of this section. Thus, pursuant to paragraph (d)(4)(ii)(B) of this section, the adjusted GILTI inclusion with respect to Share A is $6.7x, computed by—

(*1*) Adding $2.8x (the associated foreign income taxes with respect to the $32x GILTI inclusion attributable to Share A) to $32x, which is $34.8x;

(*2*) Multiplying $34.8x (the sum of the amounts in paragraph (g)(1)(v)(A)(*1*) of this section) by 50% (the difference of 100 percent and the section 250(a)(1)(B)(i) deduction percentage), which is $17.4x; and

(*3*) Subtracting $10.7x (calculated as $2.24x (80% of the $2.8x of associated foreign income taxes) divided by .21 (the percentage described in section 11(b)) from $17.4x (the product of the amounts in paragraph (g)(1)(v)(A)(*2*) of this section), which is $6.7x.

(B) Pursuant to computations similar to those discussed in paragraph (g)(1)(v)(A) of this section, the adjusted GILTI inclusion with respect to Share B is $3.3x. However, the hybrid deduction account with respect to Share B is not reduced by such $3.3x, because of the limitation in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section, which, with respect to Share B, limits the reduction pursuant to paragraph (d)(4)(i)(B)(*2*)(*i*) of this section to $0 (calculated as $0, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section (computed as $130x, the sole item of gross tested income, divided by $130x, the sole item of gross income)). *See* paragraphs (d)(4)(i)(B)(*2*)(*i*) and (*ii*) of this section.

(C) US1's hybrid deduction account with respect to Share A is reduced by the entire $6.7x adjusted GILTI inclusion with respect to the share, as such $6.7x does not exceed the limit in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section ($80x, calculated as $80x, the hybrid deductions allocated to the share for the taxable year, multiplied by 1, the fraction described in paragraph (d)(4)(i)(B)(*2*)(*ii*) of this section). *See* paragraphs (d)(4)(i)(B)(*2*)(*i*) and (*ii*) of this section. In addition, the hybrid deduction account is reduced by another $3.3x, the amount of the adjusted GILTI inclusion with respect to Share B that is allocated to the hybrid deduction account with respect to Share A. *See* paragraph (d)(4)(i)(B)(*2*)(*iii*) of this section. As a result, pursuant to paragraph (d)(4)(i)(B)(*2*) of this section, US1's hybrid deduction account with respect to Share A is reduced by $10x ($6.7x plus $3.3x).

(2) *Example 2. Tiered hybrid dividend rule; tax benefit equivalent to a deduction*—(i) *Facts.* US1 holds all the stock of FX, and FX holds all 100 shares of stock of FZ (the ''FZ shares''), which have an equal value. The FZ shares are treated as equity for Country Z tax purposes. At the end of year 1, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock is $0. During year 2, FZ distributes $10x to FX with respect to each of the FZ shares, for a total of $1,000x. The $1,000x is treated as a dividend for U.S. and Country Z tax purposes, and is not deductible for Country Z tax purposes. If FX were a domestic corporation, then, without regard to section 245A(e) and this section as well as §1.245A–5, FX would be allowed a deduction under section 245A(a) for the $1,000x. Under Country Z tax law, 75% of the corporate income tax paid by a Country Z corporation with respect to a dividend distribution is refunded to the corporation's shareholders (regardless of where such shareholders are tax residents) upon a dividend distribution by the corporation. The corporate tax rate in Country Z is 20%. With respect to FZ's distributions, FX is allowed a refundable tax credit of $187.5x. The $187.5x refundable tax credit is calculated as $1,250x (the amount of pre-tax earnings that funded the distribution, determined as $1,000x (the amount of the distribution) divided by 0.8 (the percentage of pre-tax earnings that a Country Z corporation retains after paying Country Z corporate tax)) multiplied by 0.2 (the Country Z corporate tax rate) multiplied by 0.75 (the percentage of the Country Z tax credit). Under Country Z tax law, FX is not subject to Country Z withholding tax (or any other tax) with respect to the $1,000x dividend distribution.

(ii) *Analysis.* As described in paragraphs (g)(2)(ii)(A) and (B) of this section, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock at the end of year 2 is $937.5x and, as a result, $937.5x of the $1,000x of dividends received by FX from FZ during year 2 is a tiered hybrid dividend. *See* paragraphs (b)(2) and (c)(2) of this section. The $937.5x tiered hybrid dividend is treated for purposes of section 951(a)(1)(A) as subpart F income of FX and US1 must include in gross income its pro rata share of such subpart F income, which is $937.5x. *See* paragraph (c)(1) of this section. This is the case notwithstanding any other provision of the Code, including section 952(c) or section 954(c)(3) or (6). In addition, the rules of section 245A(d) and §1.245A(d)–1 (disallowance of foreign tax credits and deductions) apply with respect to US1's inclusion. *See* paragraph (c)(1) of this section. Paragraphs (g)(2)(ii)(A) through (C) of this section describe the determinations under this section. The characterization of the FZ stock for Country X tax purposes (or for purposes of any other foreign tax law) does not affect this analysis.

(A) The $187.5x refundable tax credit allowed to FX under Country Z tax law (a relevant foreign tax law) is equivalent to a $937.5x deduction, calculated as $187.5x (the amount of the credit) divided by 0.2 (the Country Z corporate tax rate). The $937.5x is a hybrid deduction of FZ because it is allowed to FX (a person related to FZ), it relates to or results from amounts distributed with respect to instruments issued by FZ and treated as stock for U.S. tax purposes, and it has the effect of causing the earnings that funded the distributions to not be included in income under Country Z tax law. *See* paragraph (d)(2)(i) of this section. $9.375x of the hybrid deduction is allocated to each of the FZ shares, calculated as $937.5x (the amount of the hybrid deduction) multiplied by 1/100 (the value of each FZ share relative to the value of all the FZ shares). *See* paragraph (d)(3) of this section. The result would be the same if FX were instead a tax resident of Country Z (and not Country X), FX were allowed the $187.5x refundable tax credit under Country Z tax law, and under Country Z tax law FX were to not include the $1,000x in income (because, for example, Country Z tax law provides Country Z resident corporations a 100% exclusion or dividends received deduction with respect to dividends received from a resident corporation). *See* paragraph (d)(2)(i) of this section.

(B) At the end of year 2, and before the adjustments described in paragraph (d)(4)(i)(C) of this section, the sum of FX's hybrid deduction accounts with respect to each of its shares of FZ stock is $937.5x, calculated as $9.375x (the amount in each account) multiplied by 100 (the number of accounts). *See* paragraph (d)(4)(i) of this section. Accordingly, $937.5x of the $1,000x dividend received by FX from FZ during year 2 is a tiered hybrid dividend. *See* paragraphs (b)(2) and (c)(2) of this section.

(C) At the end of year 2, each of FX's hybrid deduction accounts with respect to its shares of FZ is decreased by the $9.375x in the account that gave rise to a hybrid dividend or tiered hybrid dividend during year 2. *See* paragraph (d)(4)(i)(C) of this section. Thus, following these adjustments, at the end of year 2, each of FX's hybrid deduction accounts with respect to its shares of FZ stock is $0, calculated as $9.375x (the amount in the account before the adjustments described in paragraph (d)(4)(i)(C) of this section) less $9.375x (the adjustment described in paragraph (d)(4)(i)(C) of this section with respect to the account).

(iii) *Alternative facts—imputation system that taxes shareholders*. The facts are the same as in paragraph (g)(2)(i) of this section, except that under Country Z tax law the $1,000x dividend to FX is subject to a 30% gross basis withholding tax, or $300x, and the $187.5x refundable tax credit is applied against and reduces the withholding tax to $112.5x. The $187.5x refundable tax credit provided to FX is not a hybrid deduction because FX was subject to Country Z withholding tax of $300x on the $1,000x dividend (such withholding tax being greater than the $187.5x credit). *See* paragraph (d)(2)(i) of this section. If instead FZ were allowed a $1,000x dividends paid deduction for the $1,000x dividend (and FX were not allowed the refundable tax credit) and the dividend were subject to 5% gross basis withholding tax (or $50x), then $750x of the dividends paid deduction would be a hybrid deduction, calculated as the excess of $1,000x (the dividends paid deduction) over $250x (the amount of income that under Country Z tax law would produce an amount of tax equal to the $50x of withholding tax, calculated as $50x, the amount of withholding tax, divided by 0.2, the Country Z corporate tax rate). *See* paragraph (d)(2)(i) of this section.

(h) *Applicability dates*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, this section applies to distributions made after December 31, 2017, provided that such distributions occur during taxable years ending on or after December 20, 2018. However, taxpayers may apply this section in its entirety to distributions made after December 31, 2017 and occurring during taxable years ending before December 20, 2018. In lieu of applying the regulations in this section, taxpayers may apply the provisions matching this section from the Internal Revenue Bulletin (IRB) 2019–03 (*https://www.irs.gov/pub/irs-irbs/irb19-03.pdf*) in their entirety for all taxable years ending on or before April 8, 2020.

(2) *Special rules*. Paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section (decrease of hybrid deduction accounts; rules regarding adjusted subpart F and GILTI inclusions) apply to taxable years ending on or after November 12, 2020. However, a taxpayer may choose to apply paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section to a taxable year ending before November 12, 2020, so long as the taxpayer consistently applies paragraphs (d)(4)(i)(B) and (d)(4)(ii) of this section to that taxable year and any subsequent taxable year ending before November 12, 2020.

[T.D. 9896, 85 FR 19830, Apr. 8, 2020, as amended by T.D. 9909, 85 FR 53096, Aug. 27, 2020; T.D. 9922, 85 FR 72031, Nov. 12, 2020; T.D.9959, 87 FR 324, Jan. 4, 2022]

§ 1.246–1 Deductions not allowed for dividends from certain corporations.

The deductions provided in sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), are not allowable with respect to any dividend received from:

(a) A corporation organized under the China Trade Act, 1922 (15 U.S.C. ch. 4) (see section 941); or

(b) A corporation which is exempt from tax under section 501 (relating to certain charitable, etc., organizations) or section 521 (relating to farmers' cooperative associations) for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; for

(c) A corporation to which section 931 (relating to income from sources within possessions of the United States) applies for the taxable year of the corporation in which the distribution is made or for its next preceding taxable year; or

(d) A real estate investment trust which, for its taxable year in which the distribution is made, is taxable under Part II, Subchapter M, Chapter 1 of the Code. See section 243(c)(3), paragraph (c) of § 1.243–2, section 857(c), and paragraph (d) of § 1.857–6.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6598, 27 FR 4092, Apr. 28, 1962; T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§ 1.246–2 Limitation on aggregate amount of deductions.

(a) *General rule*. The sum of the deductions allowed by sections 243(a)(1) (relating to dividends received by corporations), 244(a) (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations), except as provided in section 246(b)(2) and in paragraph (b) of this section, is limited to 85 percent of the taxable income of the corporation. The taxable income of the corporation for this purpose is computed without regard to the net operating loss deduction allowed by section 172, the deduction for dividends paid on certain preferred stock of public utilities allowed by section 247, any capital loss carryback under section 1212(a)(1), and the deductions provided in sections 243(a)(1), 244(a), and 245. For definition of the term *taxable income*, see section 63.

(b) *Effect of net operating loss*. If the shareholder corporation has a net operating loss (as determined under sec. 172) for a taxable year, the limitation provided in section 246(b)(1) and in paragraph (a) of this section is not applicable for such taxable year. In that event, the deductions provided in sections 243(a)(1), 244(a), and 245 shall be allowable for all tax purposes to the shareholder corporation for such taxable year without regard to such limitation. If the shareholder corporation does not have a net operating loss for the taxable year, however, the limitation will be applicable for all tax purposes for such taxable year. In determining whether the shareholder corporation has a net operating loss for a taxable year under section 172, the deductions allowed by sections 243(a)(1), 244(a), and 245 are to be computed without regard to the limitation provided in section 246(b)(1) and in paragraph (a) of this section.

[T.D. 6992, 34 FR 825, Jan. 18, 1969, as amended by T.D. 7301, 39 FR 963, Jan. 4, 1974]

§ 1.246–3 Exclusion of certain dividends.

(a) *In general.* Corporate taxpayers are denied, in certain cases, the dividends-received deduction provided by section 243 (dividends received by corporations), section 244 (dividends received on certain preferred stock), and section 245 (dividends received from certain foreign corporations). The above-mentioned dividends-received deductions are denied, under section 246(c)(1), to corporate shareholders:

(1) If the dividend is in respect of any share of stock which is sold or otherwise disposed of in any case where the taxpayer has held such share for 15 days or less; or

(2) If and to the extent that the taxpayer is under an obligation to make corresponding payments with respect to substantially identical stock or securities. It is immaterial whether the obligation has arisen pursuant to a short sale or otherwise.

(b) *Ninety-day rule for certain preference dividends.* In the case of any stock having a preference in dividends, a special rule is provided by section 246(c)(2) in lieu of the 15-day rule described in section 246(c)(1) and paragraph (a)(1) of this section. If the taxpayer receives dividends on such stock which are attributable to a period or periods aggregating in excess of 366 days, the holding period specified in section 246(c)(1)(A) shall be 90 days (in lieu of 15 days).

(c) *Definitions*—(1) *''Otherwise disposed of''.* As used in this section the term *otherwise disposed of* includes disposal by gift.

(2) *''Substantially identical stock or securities''.* The term *substantially identical stock or securities* is to be applied according to the facts and circumstances in each case. In general, the term has the same meaning as the corresponding terms in sections 1091 and 1233 and the regulations thereunder. See paragraph (d)(1) of § 1.1233–1.

(3) *Obligation to make corresponding payments.* (i) Section 246(c)(1)(B) of the Code denies the dividends-received deduction to a corporate taxpayer to the extent that such taxpayer is under an obligation, with respect to substantially identical stock or securities, to make payments corresponding to the dividend received. Thus, for example, where a corporate taxpayer is in both a ''long'' and ''short'' position with respect to the same stock on the date that such stock goes ex-dividend, the dividend received on the stock owned by the taxpayer will not be eligible for the dividends-received deduction to the extent that the taxpayer is obligated to make payments to cover the dividends with respect to its offsetting short position in the same stock. The dividends-received deduction is denied in such a case without regard to the length of time the taxpayer has held the stock on which such dividends are received.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. Y Corporation owns 100 shares of the Z Corporation's common stock on January 1, 1959. Z Corporation on January 15, 1959, declares a dividend of $1.00 per share payable to shareholders of record on January 30, 1959. On January 21, 1959, Y Corporation sells short 25 shares of the Z Corporation's common stock and remains in the short position on January 31, 1959, the day that Z Corporation's common stock goes ex-dividend. Y Corporation is therefore obligated to make a payment to the lender of the 25 shares of Z Corporation's common stock which were sold short, corresponding to the $1.00 a share dividend that the lender would have received on those 25 shares, or $25.00. Therefore, $25.00 of the $100.00 that the Y Corporation receives as dividends from the Z Corporation with respect to the 100 shares of common stock in which it has a long position is not eligible for the dividends-received deduction.

(d) *Determination of holding period*—(1) *In general.* Special rules are provided by paragraph (3) of section 246(c) for determining the period for which the taxpayer has held any share of stock for purposes of the restriction provided by such section. In computing the holding period the day of disposition but not the day of acquisition shall be taken into account. Also, there shall not be taken into account any day which is more than 15 days after the date on which the share of stock becomes ex-dividend. Thus, the holding period is automatically terminated at the end of such 15-day period without regard to how long the stock may be held after that date. In the case of stock qualifying under paragraph (2) of section 246(c) (as having preference in dividends) a 90-day period is substituted for the 15-day period prescribed in this subparagraph. Finally, section 1223(4), relating to holding periods in the case of wash sales, shall not apply. Therefore, tacking of the holding period of the stock disposed of to the holding period of the stock acquired where a wash sale occurs is not permitted for purposes of determining the holding period described in section 246(c).

(2) *Special rules.* Section 246(c) requires that the holding periods determined thereunder shall be appropriately reduced for any period that the taxpayer's stock holding is offset by a corresponding short position resulting from an option to sell, a contractual obligation to sell, or a short sale of, substantially identical stock or securities. The holding periods of stock held for a period of 15 days or less on the date such short position is created shall accordingly be reduced to the extent of such short position. Where the amount of stock acquired within such period exceeds the amount as to which the taxpayer establishes a short position, the stock the holding period of which must be reduced because of such short position shall be that most recently acquired within such period. If, on the date the short position is created, the amount of stock subject to the short position exceeds the amount, if any, of stock held by the taxpayer for 15 days or less, the excess shares of stock sold short shall, to the extent thereof, postpone until the termination of the short position the commencement of the holding periods of subsequently acquired stock. Stock having a preference in dividends is also subject to the rules prescribed in this subparagraph, except that the 90-day period provided by paragraph (b) of this section shall apply in lieu of the 15-day period otherwise applicable. The rules prescribed in this subparagraph may be illustrated by the following examples:

Example 1. L Company purchased 100 shares of Z Corporation's common stock during January 1959. On November 26, 1959, L Company purchased an additional 100 shares of the same stock. On December 1, 1959, Z Corporation declared a dividend payable on its common stock to shareholders of record on December 20, 1959. Also on December 1, L Company sold short 150 shares of Z Corporation's common stock. On December 16, 1959 (before the stock went ex-dividend), L Company closed its short sale with 150 shares purchased on that date. In determining, for purposes of section 246(c), whether L Company has held the 100 shares of stock acquired on November 26 for a period in excess of 15 days, the period of the short position (from December 2 through December 16) shall be excluded. Thus, if on or before December 26, 1959, L Company sold the 100 shares of Z Corporation stock which it purchased on November 26, 1959, it would not be entitled to a dividends-received deduction for the dividends received on such shares because it would have held such shares for 15 days or less on the date of the sale. Since L Company had held the 100 shares acquired during January 1959 for more than 15 days on December 2, 1959, and since it was under no obligation to make payments corresponding to the dividends received thereon, section 246(c) is inapplicable to the dividends received with respect to those shares.

Example 2. Assume the same facts as in *Example 1* above except that the additional 100 shares of Z Corporation common stock were purchased by L Company on December 10, 1959, rather than November 26, 1959. In determining, for purposes of section 246(c), whether L Company has held such shares for a period in excess of 15 days, the period from December 11, 1959, until December 16, 1959 (the date the short sale made on December 1 was closed), shall be excluded.

(e) *Effective date.* The provisions of this section shall apply to stock acquired after December 31, 1957, or with respect to stock acquired before that date where the taxpayer has made a short sale of substantially identical stock or securities after that date.

§ 1.246–4 Dividends from a DISC or former DISC.

The deduction provided in section 243 (relating to dividends received by corporations) is not allowable with respect to any dividend (whether in the form of a deemed or actual distribution or an amount treated as a dividend pursuant to section 995(c)) from a corporation which is a DISC or former DISC (as defined in section 992(a)(1) or (3) as the case may be) to the extent such dividend is from the corporation's accumulated DISC income (as defined in section 996(f)(1)) or previously taxed income (as defined in section 996(f)(2)) or is a deemed distribution pursuant to section 995(b)(1) in a taxable year for which the corporation qualifies (or is treated) as a DISC. To the extent that a dividend is paid out of earnings and profits which are not made up of accumulated DISC income or previously taxed income, the corporate recipient is entitled to the deduction provided in section 243 in the same manner and to the same extent as a dividend from a domestic corporation which is not a DISC or former DISC.

[T.D. 7283, 38 FR 20824, Aug. 3, 1973]

§ 1.246–5 Reduction of holding periods in certain situations.

(a) *In general.* Under section 246(c)(4)(C), the holding period of stock for purposes of the dividends received deduction is appropriately reduced for any period in which a taxpayer has diminished its risk of loss by holding one or more other positions with respect to substantially similar or related property. This section provides rules for applying section 246(c)(4)(C).

(b) *Definitions*—(1) *Substantially similar or related property.* The term substantially similar or related property is applied according to the facts and circumstances in each case. In general, property is substantially similar or related to stock when—

(i) The fair market values of the stock and the property primarily reflect the performance of—

(A) A single firm or enterprise;

(B) The same industry or industries; or

(C) The same economic factor or factors such as (but not limited to) interest rates, commodity prices, or foreign-currency exchange rates; and

(ii) Changes in the fair market value of the stock are reasonably expected to approximate, directly or inversely, changes in the fair market value of the property, a fraction of the fair market value of the property, or a multiple of the fair market value of the property.

(2) *Diminished risk of loss.* A taxpayer has diminished its risk of loss on its stock by holding positions with respect to substantially similar or related property if changes in the fair market values of the stock and the positions are reasonably expected to vary inversely.

(3) *Position.* For purposes of this section, a position with respect to property is an interest (including a futures or forward contract or an option) in property or any contractual right to a payment, whether or not severable from stock or other property. A position does not include traditional equity rights to demand payment from the issuer, such as the rights traditionally provided by mandatorily redeemable preferred stock.

(4) *Reasonable expectations.* For purposes of paragraphs (b)(1)(i), (b)(2), or (c)(1)(vi) of this section, reasonable expectations are the expectations of a reasonable person, based on all the facts and circumstances at the later of the time the stock is acquired or the positions are entered into. Reasonable expectations include all explicit or implicit representations made with respect to the marketing or sale of the position.

(c) *Special rules*—(1) *Positions in more than one stock*—(i) *In general.* This paragraph (c)(1) provides rules for the treatment of positions that reflect the value of more than one stock. In general, positions that reflect the value of a portfolio of stocks are treated under the rules of paragraphs (c)(1) (ii) through (iv) of this section, and positions that reflect the value of more than one stock but less than a portfolio are treated under the rules of paragraph (c)(1)(v) of this section. A portfolio for this purpose is any group of stocks of 20 or more unrelated issuers. Paragraph (c)(1)(vi) of this section provides an anti-abuse rule.

(ii) *Portfolios.* Notwithstanding paragraph (b)(1) of this section, a position reflecting the value of a portfolio of stocks is substantially similar or related to the stocks held by the taxpayer only if the position and the taxpayer's holdings substantially overlap as of the most recent testing date. A position may be substantially similar or related to a taxpayer's entire stock holdings or a portion of a taxpayer's stock holdings.

(iii) *Determining substantial overlap.* This paragraph (c)(1)(iii) provides rules for determining whether a position and a taxpayer's stock holdings or a portion of a taxpayer's stock holdings substantially overlap. Paragraphs (c)(1)(iii) (A) through (C) of this section determine whether there is substantial overlap as of any testing date.

(A) *Step One.* Construct a subportfolio (the Subportfolio) that consists of stock in an amount equal to the lesser of the fair market value of each stock represented in the position and the fair market value of the stock in the taxpayer's stock holdings. (The Subportfolio may contain fewer than 20 stocks.)

(B) *Step Two.* If the fair market value of the Subportfolio is equal to or greater than 70 percent of the fair market value of the stocks represented in the position, the position and the Subportfolio substantially overlap.

(C) *Step Three.* If the position does not substantially overlap with the Subportfolio, repeat Steps One and Two (paragraphs (c)(1)(iii)(A) and (B) of this section) reducing the size of the position. The largest percentage of the position that results in a substantial overlap is substantially similar or related to the Subportfolio determined with respect to that percentage of the position.

(iv) *Testing date.* A testing date is any day on which the taxpayer purchases or sells any stock if the fair market value of the stock or the fair market value of substantially similar or related property is reflected in the position, any day on which the taxpayer changes the position, or any day on which the composition of the position changes.

(v) *Nonportfolio positions.* A position that reflects the fair market value of more than one stock but not of a portfolio of stocks is treated as a separate position with respect to each of the stocks the value of which the position reflects.

(vi) *Anti-abuse rule.* Notwithstanding paragraphs (c)(1)(i) through (v) of this section, a position that reflects the value of more than one stock is a position in substantially similar or related property to the appropriate portion of the taxpayer's stock holdings if—

(A) Changes in the value of the position or the stocks reflected in the position are reasonably expected to virtually track (directly or inversely) changes in the value of the taxpayer's stock holdings, or any portion of the taxpayer's stock holdings and other positions of the taxpayer; and

(B) The position is acquired or held as part of a plan a principal purpose of which is to obtain tax savings (including by deferring tax) the value of which is significantly in excess of the expected pre-tax economic profits from the plan.

(2) *Options*—(i) *Options that are significantly out of the money.* For purposes of paragraph (b)(2) of this section, an option to sell that is significantly out of the money does not diminish the taxpayer's risk of loss on its stock unless the option is held as part of a strategy to substantially offset changes in the fair market value of the stock.

(ii) *Conversion rights.* Notwithstanding paragraphs (b)(1) and (2) of this section, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if it engages in the following transactions or their substantial equivalents—

(A) A short sale of common stock while holding convertible preferred stock of the same issuer and the price changes of the convertible preferred stock and the common stock are related;

(B) A short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible or common stock; or

(C) A short sale of convertible preferred stock while holding common stock.

(3) *Stacking rule.* If a taxpayer diminishes its risk of loss by holding a position in substantially similar or related property with respect to only a portion of the shares that the taxpayer holds in a particular stock, the holding period of those shares having the shortest holding period is reduced.

(4) *Guarantees, surety agreements, or similar arrangements.* A taxpayer has diminished its risk of loss on stock by holding a position in substantially similar or related property if the taxpayer is the beneficiary of a guarantee, surety agreement, or similar arrangement and the guarantee, surety agreement, or similar arrangement provides for payments that will substantially offset decreases in the fair market value of the stock.

(5) *Hedges counted only once.* A position established as a hedge of one outstanding position, transaction, or obligation of the taxpayer (other than stock) is not treated as diminishing the risk of loss with respect to any other position held by the taxpayer. In determining whether a position is established to hedge an outstanding position, transaction, or obligation of the taxpayer, substantial deference will be given to the relationships that are established in its books and records at the time the position is entered into.

(6) *Use of related persons or pass-through entities.* Positions held by a party related to the taxpayer within the meaning of sections 267(b) or 707(b)(1) are treated as positions held by the taxpayer if the positions are held with a view to avoiding the application of this section or §1.1092(d)–2. In addition, a taxpayer is treated as diminishing its risk of loss by holding substantially similar or related property if the taxpayer holds an interest in, or is the beneficiary of, a pass-through entity, intermediary, or other arrangement with a view to avoiding the application of this section or §1.1092(d)–2.

(7) *Notional principal contracts.* For purposes of this section, rights and obligations under notional principal contracts are considered separately even though payments with regard to those rights and obligations are generally netted for other purposes. Therefore, if a taxpayer is treated under the preceding sentence as receiving payments under a notional principal contract when the fair market value of the taxpayer's stock declines, the taxpayer has diminished its risk of loss by holding a position in substantially similar or related property regardless of the netting of the payments under the contract for any other purposes.

(d) *Examples.* The following examples illustrate the provisions of this section:

Example 1. General application to common stock. Corporation A and Corporation B are both automobile manufacturers. The fair market values of Corporation A and Corporation B common stock primarily reflect the value of the same industry. Because Corporation A and Corporation B common stock are affected not only by the general level of growth in the industry but also by individual corporate management decisions and corporate capital structures, changes in the fair market value of Corporation A common stock are not reasonably expected to approximate changes in the fair market value of the Corporation B common stock. Under paragraph (b)(1) of this section, Corporation A common stock is not substantially similar or related to Corporation B common stock.

Example 2. Common stock value primarily reflects commodity price. Corporation C and Corporation D both hold gold as their primary asset, and historically changes in the fair market value of Corporation C common stock approximated changes in the fair market value of Corporation D common stock. Corporation M purchased Corporation C common stock and sold short Corporation D common stock. Corporation C common stock is substantially similar or related to Corporation D common stock because their fair market values primarily reflect the performance of the same economic factor, the price of gold, and changes in the fair market value of Corporation C common stock are reasonably expected to approximate changes in the fair market value of Corporation D common stock. It was reasonably expected that changes in the fair market values of the Corporation C common stock and the short position in Corporation D common stock would vary inversely. Thus, Corporation M has diminished its risk of loss on its Corporation C common stock for purposes of section 246(c)(4)(C) and this section by holding a position in substantially similar or related property.

Example 3. Portfolios of stocks. (i) Corporation Z holds a portfolio of stocks and acquires a short position on a publicly traded index through a regulated futures contract (RFC) that reflects the value of a portfolio of stocks as defined in paragraph (c)(1)(i) of this section. The index reflects the fair market value of stocks A through T. The values of stocks reflected in the index and the values of the same stocks in Corporation Z's holdings are as follows:

Stock	Z's holdings	RFC	Subportfolio
A	$300	$300	$300
B	300	300	300
C	—	300	—
D	400	500	400
E	300	500	300
F	300	500	300
G	500	600	500
H	300	300	300
I	—	300	—
J	400	450	400
K	200	500	200
L	200	400	200
M	200	500	200
N	100	200	100
O	—	200	—
P	200	200	200
Q	100	300	100
R	200	100	100
S	100	100	100
T	100	200	100
Totals	$4,200	$6,750	$4,100

(ii) The position is substantially similar or related to Z's stock holdings only if they substantially overlap. To determine whether they substantially overlap, Corporation Z must construct a Subportfolio of stocks with the lesser of the value of the stock as reflected in the RFC and its holdings. The Subportfolio is given in the rightmost column above. The value of the Subportfolio is 60.74 percent of the value of the stocks represented in the position ($4100 ÷ $6750), so the position and the Subportfolio do not substantially overlap.

(iii) To determine whether any portion of the position substantially overlaps with any portion of the Z's stock holdings, the values of the stocks in the RFC are reduced for purposes of the above steps. Eighty percent of the position and the corresponding subportfolio (consisting of stocks with a value of the lesser of the stocks represented in Z's holdings and in 80 percent of the RFC) substantially overlap, computed as follows:

Stock	Z's holdings	80% of RFC	Subportfolio
A	$300	$240	$240
B	300	240	240
C	—	240	—
D	400	400	400
E	300	400	300
F	300	400	300
G	500	480	480
H	300	240	240
I	—	240	—
J	400	360	360
K	200	400	200
L	200	320	200
M	200	400	200
N	100	160	100
O	—	160	—
P	200	160	160
Q	100	240	100
R	200	80	80
S	100	80	80
T	100	160	100
Totals	$4,200	$5,400	$3,780

(iv) Because $3,780 is 70 percent of $5,400, the Subportfolio substantially overlaps with 80 percent of the position. Under paragraph (c)(3) of this section, Z's stocks having the shortest holding period are treated as included in the Subportfolio. A larger portion of Z's stocks may be treated as substantially similar or related property under the anti-abuse rule of paragraph (c)(1)(vi) of this section.

Example 4. Hedges counted only once. January 1, 1996, Corporation X owns a $100 million portfolio of stocks all of which would substantially overlap with a $100 million regulated futures contract (RFC) on a commonly used index (the Index). On January 15, Corporation X enters into a $100 million short position in an RFC on the Index with a March delivery date and enters into a $75 million long position in an RFC on the Index for June delivery. Also on January 15, 1996, Corporation X indicates in its books and records that the long and short RFC positions are intended to offset one another. Under paragraph (c)(5) of this section, $75 million of the short position in the RFC is not treated as diminishing the risk of loss on the stock portfolio and instead is treated as a straddle or a hedging transaction, as appropriate, with respect to the $75 million long position in the RFC, under section 1092. The remaining $25 million short position is treated as diminishing the risk of loss on the portfolio by holding a position in substantially similar or related property. The rules of paragraph (c)(1) determine how much of the portfolio is subject to this rule and the rules of paragraph (c)(3) determine which shares have their holding periods tolled.

(e) *Effective date*—(1) *In general.* The provisions of this section apply to dividends received on or after March 17, 1995, on stock acquired after July 18, 1984.

(2) *Special rule for dividends received on certain stock.* Notwithstanding paragraph (e)(1) of this section, this section applies to any dividends received by a taxpayer on stock acquired after July 18, 1984, if the taxpayer has diminished its risk of loss by holding substantially similar or related property involving the following types of transactions—

(i) The short sale of common stock when holding convertible preferred stock of the same issuer and the price changes of the two stocks are related, or the short sale of a convertible debenture while holding convertible preferred stock into which the debenture is convertible (or common stock), or a short sale of convertible preferred stock while holding common stock; or

(ii) The acquisition of a short position in a regulated futures contract on a stock index, or the acquisition of an option to sell the regulated futures contract or the stock index itself, or the grant of a deep-in-the-money option to buy the regulated futures contract or the stock index while holding the stock of an investment company whose principal holdings mimic the performance of the stocks included in the stock index; or alternatively, while holding a portfolio composed of stocks that mimic the performance of the stocks included in the stock index.

[T.D. 8590, 60 FR 14638, Mar. 20, 1995]

§ 1.247–1 Deduction for dividends paid on preferred stock of public utilities.

(a) *Amount of deduction.* (1) A deduction is provided in section 247 for dividends paid during the taxable year by certain public utility corporations (see paragraph (b) of this section) on certain preferred stock (see paragraph (c) of this section). This deduction is an amount equal to the product of a specified fraction times the lesser of (i) the amount of the dividends paid during the taxable year by a public utility on its preferred stock (as defined in paragraph (c) of this section), or (ii) the taxable income of the public utility for such taxable year (computed without regard to the deduction allowed by section 247). The specified fraction for any taxable year is the fraction the numerator of which is 14 and the denominator of which is the sum of the corporation normal tax rate and the surtax rate for such taxable year specified in section 11. Since section 11 provides that for the calendar year 1954 the corporation normal tax rate is 30 percent and the surtax rate is 22 percent, the sum of the two tax rates is 52 percent and the specified fraction for the calendar year 1954 is 14/52. If, for example, section 11 should specify that the corporation's normal tax rate is 25 percent and the surtax rate is 22 percent for the calendar year, the sum of the two tax rates will be 47 percent and the specified fraction for the calendar year will be 14/47. If Corporation A, a public utility which files its income tax return on the calendar year basis, pays $100,000 dividends on its preferred stock in the calendar year 1954 and if its taxable income for such year is greater than $100,000 the deduction allowable to Corporation A under section 247 for 1954 is $100,000 times 14/52, or $26,923.08. If in 1954 Corporation A's taxable income, computed without regard to the deduction provided in section 247, had been $90,000 (that is, less than the amount of the dividends which it paid on its preferred stock in that year), the deduction allowable under section 247 for 1954 would have been $90,000 times 14/52, or $24,230.77.

(2) For the purpose of determining the amount of the deduction provided in section 247(a) and in subparagraph (1) of this paragraph, the amount of dividends paid in a given taxable year shall not include any amount distributed in such year with respect to dividends unpaid and accumulated in any taxable year ending before October 1, 1942. If any distribution is made in the current taxable year with respect to dividends unpaid and accumulated for a prior taxable year, such distribution will be deemed to have been made with respect to the earliest year or years for which there are dividends unpaid and accumulated. Thus, if a public utility makes a distribution with respect to a prior taxable year, it shall be considered that such distribution was made with respect to the earliest year or years for which there are dividends unpaid and accumulated, whether or not the public utility states that the distribution was made with respect to such year or years and even though the public utility stated that the distribution was made with respect to a later year. Even though it has dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a public utility may, however, include the dividends paid with respect to the current taxable year in computing the deduction under section 247. If there are no dividends unpaid and accumulated with respect to a taxable year ending before October 1, 1942, a

public utility may include the dividends paid with respect to a prior taxable year which ended after October 1, 1942, in computing the deduction under section 247; such public utility in addition may include the dividends paid with respect to the current taxable year in computing the deduction under section 247. However, if local law or its own charter requires a public utility to pay all unpaid and accumulated dividends before any dividends can be paid with respect to the current taxable year, such public utility may not include any distribution in the current year in computing the deduction under section 247 to the extent that there are dividends unpaid and accumulated with respect to taxable years ending before October 1, 1942.

(3) If a corporation which is engaged in one or more of the four types of business activities (called utility activities in this section) enumerated in section 247(b)(1) (the furnishing of telephone service or the sale of electrical energy, gas, or water) is also engaged in some other business that does not fall within any of the enumerated categories, the deduction under section 247 is allowable only for such portion of the amount computed under section 247(a) as is allocable to the income from utility activities. For this purpose, the allocation may be made on the basis of the ratio which the total income from the utility activities bears to total income from all sources (total income being considered either gross income or gross receipts, whichever method results in the higher deduction). However, if such an allocation reaches an inequitable result and the books of the corporation are so kept that the taxable income attributable to the utility activities can be readily determined, particularly where the books of the corporation are required by governmental bodies to be so kept for rate making or other purposes, the allocation may be made upon the basis of taxable income. No such apportionment will be required if the income from sources other than utility activities is less than 20 percent of the total income of the corporation, irrespective of the method used in determining such total income.

(b) *Public utility*. As used in section 247 and this section, public utility means a corporation engaged in the furnishing of telephone service, or in the sale of electric energy, gas, or water if the rates charged by such corporation for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof or by an agency or instrumentality of the United States or by a public utility or public service commission or other similar body of the District of Columbia or of any State or political subdivision thereof. If a schedule of rates has been filed with any of the above bodies having the power to disapprove such rates, then such rates shall be considered as established or approved rates even though such body has taken no action on the filed schedule. Rates fixed by contract between the corporation and the purchaser, except where the purchaser is the United States, a State, the District of Columbia, or an agency or political subdivision of the United States, a State, or the District of Columbia, shall not be considered as established or approved rates in those cases where they are not subject to direct control, or where no maximum rate for such contract rates has been established by the United States, a State, the District of Columbia, or by an agency or political subdivision thereof. The deduction provided in section 247 will not be denied solely because part of the gross income of the corporation consists of revenue derived from such furnishing or sale at rates which are not so regulated, provided the corporation establishes to the satisfaction of the Commissioner (1) that the revenue from regulated rates and the revenue from unregulated rates are derived from the operation of a single interconnected and coordinated system within a single area or region in one or more States, or from the operation of more than one such system and (2) that the regulation to which it is subject in part of its operating territory in one such system is effective to control rates within the unregulated territory of the same system so that the rates within the unregulated territory have been and are substantially as favorable to users and consumers as are the rates within the regulated territory.

(c) *Preferred stock.* (1) For the purposes of section 247 and this section, preferred stock means stock (i) which was issued before October 1, 1942, (ii) the dividends in respect of which (during the whole of the taxable year, or the part of the taxable year after the actual date of the issue of such stock) were cumulative, nonparticipating as to current distributions, and payable in preference to the payment of dividends on other stock, and (iii) the rate of return on which is fixed and cannot be changed by a vote of the board of directors or by some similar method. However, if there are several classes of preferred stock, all of which meet the above requirements, the deduction provided in section 247 shall not be denied in the case of a given class of preferred stock merely because there is another class of preferred stock whose dividends are to be paid before those of the given class of stock. Likewise, it is immaterial for the purposes of section 247 and this section whether the stock be voting or nonvoting stock.

(2) Preferred stock issued on or after October 1, 1942, under certain circumstances will be considered as having been issued before October 1, 1942, for purposes of the deduction provided in section 247. If the new stock is issued on or after October 1, 1942, to refund or replace bonds or debentures which were issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), such new stock shall be considered as having been issued before October 1, 1942. If preferred stock is issued to refund or replace stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), it shall be immaterial whether the preferred stock so refunded or replaced was issued before, on, or after October 1, 1942. If stock issued on or after October 1, 1942, to refund or replace stock which was issued before October 1, 1942, and which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), is not itself preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), no stock issued to refund or replace such stock can be considered preferred stock for purposes of the deduction provided in section 247.

(3) In the case of any preferred stock issued on or after October 1, 1942, to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other stock which was preferred stock within the meaning of section 247(b)(2) (or the corresponding provision of the Internal Revenue Code of 1939), only that portion of the stock issued on or after October 1, 1942, will be considered as having been issued before October 1, 1942, the par or stated value of which does not exceed the par, stated, or face value of such bonds, debentures, or other preferred stock which the new stock was issued to refund or replace. In such case no shares of the new stock issued on or after October 1, 1942, shall be earmarked in determining the deduction allowable under section 247, but the appropriate allocable portion of the total amount of dividends paid on such stock will be considered as having been paid on stock which was issued before October 1, 1942.

(4) The provisions of section 247(b)(2) may be illustrated by the following example:

Example. A public utility has outstanding 1,000 bonds which were issued before October 1, 1942, and each of which has a face value of $100. On or after October 1, 1942, each of such bonds is retired in exchange for $1\frac{1}{10}$ shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only $\frac{10}{11}$ of the dividends paid on the preferred stock thus issued in exchange for the bonds will be considered as having been paid on stock which was issued before October 1, 1942. Likewise, if preferred stock which is issued on or after October 1, 1942, has no par value but a stated value of $50 per share and such stock is issued in a ratio of three shares to one share to refund or replace preferred stock having a par value of $100 per share, only two-thirds of the dividends paid on the new shares of stock will be considered as having been paid on stock which was issued before October 1, 1942.

(5) Whether or not preferred stock issued on or after October 1, 1942, was

issued to refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, is in each case a question of fact. Among the factors to be considered is whether such stock is new in an economic sense to the corporation or whether it was issued merely to take the place, directly or indirectly, of bonds, debentures, or other preferred stock of such corporation. It is not necessary that the new preferred stock be issued in exchange for such bonds, debentures, or other preferred stock. The mere fact that the bonds, debentures, or other preferred stock remain in existence for a short period of time after the issuance of the new stock (or were retired before the issuance of the new stock) does not necessarily mean that such new stock was not issued to refund or replace such bonds, debentures, or other preferred stock. It is necessary to consider the entire transaction, including the issuance of the new preferred stock, the date of such issuance, the retirement of the old bonds, debentures, or preferred stock, and the date of such retirement, in order to determine whether such new stock really was issued to take the place of bonds, debentures, or other preferred stock of the corporation or whether it represents something essentially new in an economic sense in the corporation's financial structure. If, for example, a public utility, which has outstanding bonds issued before October 1, 1942, issues new preferred stock on October 1, 1954, in order to secure funds with which to retire such bonds and with the money paid in for such stock retires the bonds on November 1, 1954, such stock may be considered as having been issued to refund or replace bonds issued before October 1, 1942. Whether the money used to retire the bonds can be traced back and identified as the money paid in for the stock will have evidentiary value, but will not be conclusive, in determining whether the stock was issued to refund or replace the bonds. Similarly, whether the amount of money used to retire the bonds was smaller than, equal to, or greater than that paid in for the stock, or whether the entire issue of bonds is retired, will be important, but not decisive, in making such determination.

(6) Preferred stock issued on or after October 1, 1942, by a corporation to refund or replace bonds or debentures of a second corporation which were issued before October 1, 1942, or to refund or replace other preferred stock of such second corporation, may be considered as having been issued before October 1, 1942, if such new stock was issued (i) in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939; or (ii) in a transaction to which section 371 (relating to insolvency reorganizations), or the corresponding provisions of the Internal Revenue Code of 1939, is applicable; or (iii) in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission) or to the corresponding provisions of the Internal Revenue Code of 1939. Whether the stock actually was issued to refund or replace bonds or debentures of the second corporation issued before October 1, 1942, or to refund or replace preferred stock of such second corporation, shall be determined under the same principles as if only one corporation were involved. A corporation may issue stock to refund or replace its own bonds, debentures, or other preferred stock in a transaction which is a reorganization within the meaning of section 368(a) or the corresponding provisions of the Internal Revenue Code of 1939, in a transaction to which section 371 or the corresponding provisions of the Internal Revenue Code of 1939 is applicable, or in a transaction which is subject to the provisions of Part VI, Subchapter O, Chapter 1 of the Code, or to the corresponding provisions of the Internal Revenue Code of 1939. The provisions of this paragraph, in addition, are applicable in case a corporation issues stock on or after October 1, 1942, to refund or replace its own bonds, debentures, or other preferred stock even though the issuance of such stock may not fall within one of the categories enumerated above.

(7) Even though stock issued on or after October 1, 1942, is considered as having been issued before October 1, 1942, by reason of having been issued to

refund or replace bonds or debentures issued before October 1, 1942, or to refund or replace other preferred stock, such stock will not be deemed to be preferred stock within the meaning of section 247(b)(2), and no deduction will be allowable in respect of dividends paid on such stock, unless the stock fulfills all the other requirements of a preferred stock set forth in section 247(b)(2) and in this paragraph.

§ 1.248–1 Election to amortize organizational expenditures.

(a) *In general.* Under section 248(a), a corporation may elect to amortize organizational expenditures as defined in section 248(b) and § 1.248–1(b). In the taxable year in which a corporation begins business, an electing corporation may deduct an amount equal to the lesser of the amount of the organizational expenditures of the corporation, or $5,000 (reduced (but not below zero) by the amount by which the organizational expenditures exceed $50,000). The remainder of the organizational expenditures is deducted ratably over the 180-month period beginning with the month in which the corporation begins business. All organizational expenditures of the corporation are considered in determining whether the organizational expenditures exceed $50,000, including expenditures incurred on or before October 22, 2004.

(b) *Organizational expenditures defined.* (1) Section 248(b) defines the term *organizational expenditures.* Such expenditures, for purposes of section 248 and this section, are those expenditures which are directly incident to the creation of the corporation. An expenditure, in order to qualify as an organizational expenditure, must be (i) incident to the creation of the corporation, (ii) chargeable to the capital account of the corporation, and (iii) of a character which, if expended incident to the creation of a corporation having a limited life, would be amortizable over such life. An expenditure which fails to meet each of these three tests may not be considered an organizational expenditure for purposes of section 248 and this section.

(2) The following are examples of organizational expenditures within the meaning of section 248 and this section: legal services incident to the organization of the corporation, such as drafting the corporate charter, by-laws, minutes of organizational meetings, terms of original stock certificates, and the like; necessary accounting services; expenses of temporary directors and of organizational meetings of directors or stockholders; and fees paid to the State of incorporation.

(3) The following expenditures are not organizational expenditures within the meaning of section 248 and this section:

(i) Expenditures connected with issuing or selling shares of stock or other securities, such as commissions, professional fees, and printing costs. This is so even where the particular issue of stock to which the expenditures relate is for a fixed term of years;

(ii) Expenditures connected with the transfer of assets to a corporation.

(4) Expenditures connected with the reorganization of a corporation, unless directly incident to the creation of a corporation, are not organizational expenditures within the meaning of section 248 and this section.

(c) *Time and manner of making election.* A corporation is deemed to have made an election under section 248(a) to amortize organizational expenditures as defined in section 248(b) and § 1.248–1(b) for the taxable year in which the corporation begins business. A corporation may choose to forgo the deemed election by affirmatively electing to capitalize its organizational expenditures on a timely filed Federal income tax return (including extensions) for the taxable year in which the corporation begins business. The election either to amortize organizational expenditures under section 248(a) or to capitalize organizational expenditures is irrevocable and applies to all organizational expenditures of the corporation. A change in the characterization of an item as an organizational expenditure is a change in method of accounting to which sections 446 and 481(a) apply if the corporation treated the item consistently for two or more taxable years. A change in the determination of the taxable year in which the corporation begins business also is treated as a change in method of accounting if the corporation amortized organizational expenditures for two or more taxable years.

(d) *Determination of when corporation begins business.* The deduction allowed under section 248 must be spread over a period beginning with the month in which the corporation begins business. The determination of the date the corporation begins business presents a question of fact which must be determined in each case in light of all the circumstances of the particular case. The words ''begins business,'' however, do not have the same meaning as ''in existence.'' Ordinarily, a corporation begins business when it starts the business operations for which it was organized; a corporation comes into existence on the date of its incorporation. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to show the beginning of business. If the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations, however, it will be deemed to have begun business. For example, the acquisition of operating assets which are necessary to the type of business contemplated may constitute the beginning of business.

(e) *Examples.* The following examples illustrate the application of this section:

Example 1. Expenditures of $5,000 or less Corporation X, a calendar year taxpayer, incurs $3,000 of organizational expenditures after October 22, 2004, and begins business on July 1, 2011. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2011. Therefore, Corporation X may deduct the entire amount of the organizational expenditures in 2011, the taxable year in which Corporation X begins business.

Example 2. Expenditures of more than $5,000 but less than or equal to $50,000 The facts are the same as in *Example 1* except that Corporation X incurs organizational expenditures of $41,000. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2011. Therefore, Corporation X may deduct $5,000 and the portion of the remaining $36,000 that is allocable to July through December of 2011 ($36,000/180 × 6 = $1,200) in 2011, the taxable year in which Corporation X begins business. Corporation X may amortize the remaining $34,800 ($36,000 − $1,200 = $34,800) ratably over the remaining 174 months.

Example 3. Subsequent change in the characterization of an item The facts are the same as in *Example 2* except that Corporation X determines in 2013 that Corporation X incurred $10,000 for an additional organizational expenditure erroneously deducted in 2011 under section 162 as a business expense. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2011, including the additional $10,000 of organizational expenditures. Corporation X is using an impermissible method of accounting for the additional $10,000 of organizational expenditures and must change its method under §1.446–1(e) and the applicable general administrative procedures in effect in 2013.

Example 4. Subsequent redetermination of year in which business begins The facts are the same as in *Example 2* except that, in 2012, Corporation X deducted the organizational expenditures allocable to January through December of 2012 ($36,000/180 × 12 = $2,400). In addition, in 2013 it is determined that Corporation X actually began business in 2012. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2012. Corporation X impermissibly deducted organizational expenditures in 2011, and incorrectly determined the amount of organizational expenditures deducted in 2012. Therefore, Corporation X is using an impermissible method of accounting for the organizational expenditures and must change its method under §1.446–1(e) and the applicable general administrative procedures in effect in 2013.

Example 5. Expenditures of more than $50,000 but less than or equal to $55,000 The facts are the same as in *Example 1* except that Corporation X incurs organizational expenditures of $54,500. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2011. Therefore, Corporation X may deduct $500 ($5,000 − $4,500) and the portion of the remaining $54,000 that is allocable to July through December of 2011 ($54,000/180 × 6 = $1,800) in 2011, the taxable year in which Corporation X begins business. Corporation X may amortize the remaining $52,200 ($54,000 − $1,800 = $52,200) ratably over the remaining 174 months.

Example 6. Expenditures of more than $55,000 The facts are the same as in *Example 1* except that Corporation X incurs organizational expenditures of $450,000. Under paragraph (c) of this section, Corporation X is deemed to have elected to amortize organizational expenditures under section 248(a) in 2011. Therefore, Corporation X may deduct the amounts allocable to July through December of 2011 ($450,000/180 × 6 = $15,000) in 2011, the taxable year in which Corporation X begins business. Corporation X may amortize the remaining $435,000 ($450,000 − $15,000 = $435,000) ratably over the remaining 174 months.

(f) *Effective/applicability date.* This section applies to organizational expenditures paid or incurred after August 16, 2011. However, taxpayers may apply all the provisions of this section to organizational expenditures paid or incurred after October 22, 2004, provided that the period of limitations on assessment of tax for the year the election under paragraph (c) of this section is deemed made has not expired. For organizational expenditures paid or incurred on or before September 8, 2008, taxpayers may instead apply §1.248–1, as in effect prior to that date (§1.248–1 as contained in 26 CFR part 1 edition revised as of April 1, 2008).

[T.D. 9411, 73 FR 38913, July 8, 2008, as amended by T.D. 9542, 76 FR 50889, Aug. 17, 2011]

§ 1.249–1 Limitation on deduction of bond premium on repurchase.

(a) *Limitation*—(1) *General rule.* No deduction is allowed to the issuing corporation for any ''repurchase premium'' paid or incurred to repurchase a convertible obligation to the extent the repurchase premium exceeds a ''normal call premium.''

(2) *Exception.* Under paragraph (e) of this section, the preceding sentence shall not apply to the extent the corporation demonstrates that such excess is attributable to the cost of borrowing and not to the conversion feature.

(b) *Obligations*—(1) *Definition.* For purposes of this section, the term *obligation* means any bond, debenture, note, or certificate or other evidence of indebtedness.

(2) *Convertible obligation.* Section 249 applies to an obligation which is convertible into the stock of the issuing corporation or a corporation which, at the time the obligation is issued or repurchased, is in control of or controlled by the issuing corporation. For purposes of this subparagraph, the term *control* has the meaning assigned to such term by section 368(c).

(3) *Comparable nonconvertible obligation.* A nonconvertible obligation is comparable to a convertible obligation if both obligations are of the same grade and classification, with the same issue and maturity dates, and bearing the same rate of interest. The term *comparable nonconvertible obligation* does not include any obligation which is convertible into property.

(c) *Repurchase premium.* For purposes of this section, the term *repurchase premium* means the excess of the repurchase price paid or incurred to repurchase the obligation over its adjusted issue price (within the meaning of §1.1275–1(b)) as of the repurchase date. For the general rules applicable to the deductibility of repurchase premium, see §1.163–7(c). This paragraph (c) applies to convertible obligations repurchased on or after March 2, 1998.

(d) *Normal call premium*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph, for purposes of this section, a *normal call premium* on a convertible obligation is an amount equal to a normal call premium on a nonconvertible obligation which is comparable to the convertible obligation. A normal call premium on a comparable nonconvertible obligation is a call premium specified in dollars under the terms of such obligation. Thus, if such a specified call premium is constant over the entire term of the obligation, the normal call premium is the amount specified. If, however, the specified call premium varies during the period the comparable nonconvertible obligation is callable or if such obligation is not callable over its entire term, the normal call premium is the amount specified for the period during the term of such comparable nonconvertible obligation which corresponds to the period during which the convertible obligation was repurchased.

(2) *One-year's interest rule.* For a convertible obligation repurchased on or after March 2, 1998, a call premium specified in dollars under the terms of the obligation is considered to be a normal call premium on a nonconvertible obligation if the call premium applicable when the obligation is repurchased does not exceed an amount equal to the interest (including original issue discount) that otherwise would be deductible for the taxable year of repurchase (determined as if the obligation were not repurchased). The provisions of this subparagraph

shall not apply if the amount of interest payable for the corporation's taxable year is subject under the terms of the obligation to any contingency other than repurchase prior to the close of such taxable year.

(e) *Exception*—(1) *In general*. If a repurchase premium exceeds a normal call premium, the general rule of paragraph (a) (1) of this section does not apply to the extent that the corporation demonstrates to the satisfaction of the Commissioner or his delegate that such repurchase premium is attributable to the cost of borrowing and is not attributable to the conversion feature. For purposes of this paragraph, if a normal call premium cannot be established under paragraph (d) of this section, the amount thereof shall be considered to be zero.

(2) *Determination of the portion of a repurchase premium attributable to the cost of borrowing and not attributable to the conversion feature*. (i) For purposes of subparagraph (1) of this paragraph, the portion of a repurchase premium which is attributable to the cost of borrowing and which is not attributable to the conversion feature is the amount by which the selling price of the convertible obligation increased between the dates it was issued and repurchased by reason of a decline in yields on comparable nonconvertible obligations traded on an established securities market or, if such comparable traded obligations do not exist, by reason of a decline in yields generally on nonconvertible obligations which are as nearly comparable as possible.

(ii) In determining the amount under paragraph (e)(2)(i) of this section, appropriate consideration shall be given to all factors affecting the selling price or yields of comparable nonconvertible obligations. Such factors include general changes in prevailing yields of comparable obligations between the dates the convertible obligation was issued and repurchased and the amount (if any) by which the selling price of the nonconvertible obligation was affected by reason of any change in the issuing corporation's credit quality or the credit quality of the obligation during such period (determined on the basis of widely published financial information or on the basis of other relevant facts and circumstances which reflect the relative credit quality of the corporation or the comparable obligation).

(iii) The relationship between selling price and yields in subdivision (i) of this subparagraph shall ordinarily be determined by means of standard bond tables.

(f) *Effective/applicability dates*—(1) *In general*. Under section 414(c) of the Tax Reform Act of 1969, the provisions of section 249 and this section shall apply to any repurchase of a convertible obligation occurring after April 22, 1969, other than a convertible obligation repurchased pursuant to a binding obligation incurred on or before April 22, 1969, to repurchase such convertible obligation at a specified call premium. A binding obligation on or before such date may arise if, for example, the issuer irrevocably obligates itself, on or before such date, to repurchase the convertible obligation at a specified price after such date, or if, for example, the issuer, without regard to the terms of the convertible obligation, negotiates a contract which, on or before such date, irrevocably obligates the issuer to repurchase the convertible obligation at a specified price after such date. A binding obligation on or before such date does not include a privilege in the convertible obligation permitting the issuer to call such convertible obligation after such date, which privilege was not exercised on or before such date.

(2) *Effect on transactions not subject to this section*. No inferences shall be drawn from the provisions of section 249 and this section as to the proper treatment of transactions not subject to such provisions because of the effective date limitations thereof. For provisions relating to repurchases of convertible bonds or other evidences of indebtedness to which section 249 and this section do not apply, see §§ 1.163–3(c) and 1.163–4(c).

(3) *Portion of repurchase premium attributable to cost of borrowing*. Paragraph (e)(2)(ii) of this section applies to any repurchase of a convertible obligation occurring on or after July 6, 2011.

(g) *Example*. The provisions of this section may be illustrated by the following example:

Example. On May 15, 1968, corporation A issues a callable 20-year convertible bond at face for $1,000 bearing interest at 10 percent per annum. The bond is convertible at any time into 2 shares of the common stock of corporation A. Under the terms of the bond, the applicable call price prior to May 15, 1975, is $1,100. On June 1, 1974, corporation A calls the bond for $1,100. Since the repurchase premium, $100 (i.e., $1,100 minus $1,000), was specified in dollars in the obligation and does not exceed 1 year's interest at the rate fixed in the obligation, the $100 is considered under paragraph (d) (2) of this section to be a normal call premium on a comparable nonconvertible obligation. Accordingly, A may deduct the $100 under §1.163–3(c).

[T.D. 7259, 38 FR 4254, Feb. 12, 1973, as amended by T.D. 8746, 62 FR 68182, Dec. 31, 1997; T.D. 9533, 76 FR 39281, July 6, 2011; T.D. 9637, 78 FR 54759, Sept. 6, 2013]

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(i) Sale of property in an unrelated party transaction.
(ii) Use of property in an unrelated party transaction.
(2) Treatment of foreign related party as seller or renderer.
(3) Transactions between related parties.
(4) Example.
(d) Related party services.
(1) In general.
(2) Substantially similar services.
(3) Special rules.
(i) Rules for determining the location of and price paid by recipients of a service provided by a related party.
(ii) Rules for allocating the benefits provided by and price paid to the renderer of a related party service.
(4) Examples.

[T.D. 9901, 85 FR 43080, July 15, 2020, as amended by 85 FR 60910, Sept. 29, 2020]

§ 1.250–1 Introduction.

(a) *Overview.* Sections 1.250(a)–1 and 1.250(b)–1 through 1.250(b)–6 provide rules to determine a domestic corporation's section 250 deduction. Section 1.250(a)–1 provides rules to determine the amount of a domestic corporation's deduction for foreign-derived intangible income and global intangible low-taxed income. Section 1.250(b)–1 provides general rules and definitions regarding the computation of foreign-derived intangible income. Section 1.250(b)–2 provides rules for determining a domestic corporation's qualified business asset investment. Section 1.250(b)–3 provides general rules and definitions regarding the determination of gross foreign-derived deduction eligible income. Section 1.250(b)–4 provides rules regarding the determination of gross foreign-derived deduction eligible income from the sale of property. Section 1.250(b)–5 provides rules regarding the determination of gross foreign-derived deduction eligible income from the provision of a service. Section 1.250(b)–6 provides rules regarding the sale of property or provision of a service to a related party.

(b) *Applicability dates.* Except as otherwise provided in this paragraph (b), §§ 1.250(a)–1 and 1.250(b)–1 through

1.250(b)–6 apply to taxable years beginning on or after January 1, 2021. Section 1.250(b)–2(h)applies to taxable years ending on or after March 4, 2019. The last sentence in §1.250(b)–2(e)(2) applies to taxable years beginning after December 31, 2017.

[T.D. 9901, 85 FR 43080, July 15, 2020, as amended by 85 FR 68249, Oct. 28, 2020; T.D. 9956, 86 FR 52972, Sept. 24, 2021]

§ 1.250(a)–1 Deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).

(a) *Scope.* This section provides rules for determining the amount of a domestic corporation's deduction for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI). Paragraph (b) of this section provides general rules for determining the amount of the deduction. Paragraph (c) of this section provides definitions relevant for determining the amount of the deduction. Paragraph (d) of this section provides reporting requirements for a domestic corporation claiming the deduction. Paragraph (e) of this section provides a rule for determining the amount of the deduction of a member of a consolidated group. Paragraph (f) of this section provides examples illustrating the application of this section.

(b) *Allowance of deduction*—(1) *In general.* A domestic corporation is allowed a deduction for any taxable year equal to the sum of—

(i) 37.5 percent of its foreign-derived intangible income for the year; and

(ii) 50 percent of—

(A) Its global intangible low-taxed income for the year; and

(B) The amount treated as a dividend received by the corporation under section 78 which is attributable to its GILTI for the year.

(2) *Taxable income limitation.* In the case of a domestic corporation with a section 250(a)(2) amount for a taxable year, for purposes of applying paragraph (b)(1) of this section for the year—

(i) The corporation's FDII for the year (if any) is reduced (but not below zero) by an amount that bears the same ratio to the corporation's section 250(a)(2) amount that the corporation's FDII for the year bears to the sum of the corporation's FDII and GILTI for the year; and

(ii) The corporation's GILTI for the year (if any) is reduced (but not below zero) by the excess of the corporation's section 250(a)(2) amount over the amount of the reduction described in paragraph (b)(2)(i) of this section.

(3) *Reduction in deduction for taxable years after 2025.* For any taxable year of a domestic corporation beginning after December 31, 2025, paragraph (b)(1) of this section applies by substituting—

(i) 21.875 percent for 37.5 percent in paragraph (b)(1)(i) of this section; and

(ii) 37.5 percent for 50 percent in paragraph (b)(1)(ii) of this section.

(4) *Treatment under section 4940.* For purposes of section 4940(c)(3)(A), a deduction under section 250(a) is not treated as an ordinary and necessary expense paid or incurred for the production or collection of gross investment income.

(c) *Definitions.* The following definitions apply for purposes of this section.

(1) *Domestic corporation.* The term *domestic corporation* has the meaning set forth in section 7701(a), but does not include a regulated investment company (as defined in section 851), a real estate investment trust (as defined in section 856), or an S corporation (as defined in section 1361).

(2) *Foreign-derived intangible income (FDII).* The term *foreign-derived intangible income* or *FDII* has the meaning set forth in §1.250(b)–1(b).

(3) *Global intangible low-taxed income (GILTI).* The term *global intangible low-taxed income* or *GILTI* means, with respect to a domestic corporation for a taxable year, the corporation's GILTI inclusion amount under §1.951A–1(c) for the taxable year.

(4) *Section 250(a)(2) amount.* The term *section 250(a)(2) amount* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the sum of the corporation's FDII and GILTI (determined without regard to section 250(a)(2) and paragraph (b)(2) of this section), over the corporation's taxable income. For a corporation that is subject to the unrelated business income tax under section 511, taxable income is determined only by reference

to that corporation's unrelated business taxable income defined under section 512.

(5) *Taxable income*—(i) *In general.* The term *taxable income* has the meaning set forth in section 63(a) determined without regard to the deduction allowed under section 250 and this section.

(ii) [Reserved]

(d) *Reporting requirement.* Each domestic corporation (or individual making an election under section 962) that claims a deduction under section 250 for a taxable year must make an annual return on Form 8993, ''Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)'' (or any successor form) for such year, setting forth the information, in such form and manner, as Form 8993 (or any successor form) or its instructions prescribe. Returns on Form 8993 (or any successor form) for a taxable year must be filed with the domestic corporation's (or in the case of a section 962 election, the individual's) income tax return on or before the due date (taking into account extensions) for filing the corporation's (or in the case of a section 962 election, the individual's) income tax return.

(e) *Determination of deduction for consolidated groups.* A member of a consolidated group (as defined in §1.1502–1(h)) determines its deduction under section 250(a) and this section under the rules provided in §1.1502–50(b).

(f) *Example: Application of the taxable income limitation.* The following example illustrates the application of this section. For purposes of the example, it is assumed that DC is a domestic corporation that is not a member of a consolidated group and the taxable year of DC begins after 2017 and before 2026.

(1) *Facts.* For the taxable year, without regard to section 250(a)(2) and paragraph (b)(2) of this section, DC has FDII of $100x and GILTI of $300x. DC's taxable income (without regard to section 250(a) and this section) is $300x.

(2) *Analysis.* DC has a section 250(a)(2) amount of $100x, which is equal to the excess of the sum of DC's FDII and GILTI of $400x ($100x + $300x) over its taxable income of $300x. As a result, DC's FDII and GILTI are reduced, in the aggregate, by $100x under section 250(a)(2) and paragraph (b)(2) of this section for purposes of calculating DC's deduction allowed under section 250(a)(1) and paragraph (b)(1) of this section. DC's FDII is reduced by $25x, the amount that bears the same ratio to the section 250(a)(2) amount ($100x) as DC's FDII ($100x) bears to the sum of DC's FDII and GILTI ($400x). DC's GILTI is reduced by $75x, which is the remainder of the section 250(a)(2) amount ($100x − $25x). Therefore, for purposes of calculating its deduction under section 250(a)(1) and paragraph (b)(1) of this section, DC's FDII is $75x ($100x − $25x) and its GILTI is $225x ($300x − $75x). Accordingly, DC is allowed a deduction for the taxable year under section 250(a)(1) and paragraph (b)(1) of this section of $140.63x ($75x × 0.375 + $225x × 0.50).

[T.D. 9901, 85 FR 43080, July 15, 2020]

§ 1.250(b)–1 Computation of foreign-derived intangible income (FDII).

(a) *Scope.* This section provides rules for computing FDII. Paragraph (b) of this section defines FDII. Paragraph (c) of this section provides definitions that are relevant for computing FDII. Paragraph (d) of this section provides rules for computing gross income and allocating and apportioning deductions for purposes of computing deduction eligible income (DEI) and foreign-derived deduction eligible income (FDDEI). Paragraph (e) of this section provides rules for computing the DEI and FDDEI of a domestic corporate partner. Paragraph (f) of this section provides a rule for computing the FDII of a member of a consolidated group. Paragraph (g) of this section provides a rule for computing the FDII of a tax-exempt corporation.

(b) *Definition of FDII.* Subject to the provisions of this section, the term *FDII* means, with respect to a domestic corporation for a taxable year, the corporation's deemed intangible income for the year multiplied by the corporation's foreign-derived ratio for the year.

(c) *Definitions.* This paragraph (c) provides definitions that apply for purposes of this section and §§1.250(b)–2 through 1.250(b)–6.

(1) *Controlled foreign corporation.* The term *controlled foreign corporation* has the meaning set forth in section 957(a) and §1.957–1(a).

(2) *Deduction eligible income.* The term *deduction eligible income* or *DEI* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's gross DEI for the year over the deductions properly allocable to gross DEI for the year, as determined under paragraph (d)(2) of this section.

(3) *Deemed intangible income.* The term *deemed intangible income* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's DEI for the year over the corporation's deemed tangible income return for the year.

(4) *Deemed tangible income return.* The term *deemed tangible income return* means, with respect to a domestic corporation and a taxable year, 10 percent of the corporation's qualified business asset investment for the year.

(5) *Dividend.* The term *dividend* has the meaning set forth in section 316, and includes any amount treated as a dividend under any other provision of subtitle A of the Internal Revenue Code or the regulations in this part (for example, under section 78, 356(a)(2), 367(b), or 1248).

(6) *Domestic corporation.* The term *domestic corporation* has the meaning set forth in §1.250(a)–1(c)(1).

(7) *Domestic oil and gas extraction income.* The term *domestic oil and gas extraction income* means income described in section 907(c)(1), substituting ''within the United States'' for ''without the United States.'' A taxpayer must use a consistent method to determine the amount of its domestic oil and gas extraction income (''DOGEI'') and its foreign oil and gas extraction income (''FOGEI'') from the sale of oil or gas that has been transported or processed. For example, a taxpayer must use a consistent method to determine the amount of FOGEI from the sale of gasoline from foreign crude oil sources in computing the exclusion from gross tested income under §1.951A–2(c)(1)(v) and the amount of DOGEI from the sale of gasoline from domestic crude oil sources in computing its section 250 deduction.

(8) *FDDEI sale.* The term *FDDEI sale* has the meaning set forth in §1.250(b)–4(b).

(9) *FDDEI service.* The term *FDDEI service* has the meaning set forth in §1.250(b)–5(b).

(10) *FDDEI transaction.* The term *FDDEI transaction* means a FDDEI sale or a FDDEI service.

(11) *Foreign branch income.* The term *foreign branch income* has the meaning set forth in section 904(d)(2)(J) and §1.904–4(f)(2).

(12) *Foreign-derived deduction eligible income.* The term *foreign-derived deduction eligible income* or *FDDEI* means, with respect to a domestic corporation for a taxable year, the excess (if any) of the corporation's gross FDDEI for the year, over the deductions properly allocable to gross FDDEI for the year, as determined under paragraph (d)(2) of this section.

(13) *Foreign-derived ratio.* The term *foreign-derived ratio* means, with respect to a domestic corporation for a taxable year, the ratio (not to exceed one) of the corporation's FDDEI for the year to the corporation's DEI for the year. If a domestic corporation has no FDDEI for a taxable year, the corporation's foreign-derived ratio is zero for the taxable year.

(14) *Gross RDEI.* The term *gross RDEI* means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the corporation or partnership's gross DEI for the year that is not included in gross FDDEI.

(15) *Gross DEI.* The term *gross DEI* means, with respect to a domestic corporation or a partnership for a taxable year, the gross income of the corporation or partnership for the year determined without regard to the following items of gross income—

(i) Amounts included in gross income under section 951(a)(1);

(ii) GILTI (as defined in §1.250(a)–1(c)(3));

(iii) Financial services income (as defined in section 904(d)(2)(D) and §1.904–4(e)(1)(ii));

(iv) Dividends received from a controlled foreign corporation with respect to which the corporation or partnership is a United States shareholder;

(v) Domestic oil and gas extraction income; and

(vi) Foreign branch income.

(16) *Gross FDDEI.* The term *gross FDDEI* means, with respect to a domestic corporation or a partnership for a taxable year, the portion of the gross DEI of the corporation or partnership for the year which is derived from all of its FDDEI transactions.

(17) *Modified affiliated group*—(i) *In general.* The term *modified affiliated group* means an affiliated group as defined in section 1504(a) determined by substituting ''more than 50 percent'' for ''at least 80 percent'' each place it appears, and without regard to section 1504(b)(2) and (3).

(ii) *Special rule for noncorporate entities.* Any person (other than a corporation) that is controlled by one or more members of a modified affiliated group (including one or more persons treated as a member or members of a modified affiliated group by reason of this paragraph (c)(17)(ii)) or that controls any such member is treated as a member of the modified affiliated group.

(iii) *Definition of control.* For purposes of paragraph (c)(17)(ii) of this section, the term *control* has the meaning set forth in section 954(d)(3).

(18) *Qualified business asset investment.* The term *qualified business asset investment* or *QBAI* has the meaning set forth in § 1.250(b)–2(b).

(19) *Related party.* The term *related party* means, with respect to any person, any member of a modified affiliated group that includes such person.

(20) *United States shareholder.* The term *United States shareholder* has the meaning set forth in section 951(b) and § 1.951–1(g).

(d) *Treatment of cost of goods sold and allocation and apportionment of deductions*—(1) *Cost of goods sold for determining gross DEI and gross FDDEI.* For purposes of determining the gross income included in gross DEI and gross FDDEI of a domestic corporation or a partnership, the cost of goods sold of the corporation or partnership is attributed to gross receipts with respect to gross DEI or gross FDDEI under any reasonable method that is applied consistently. Cost of goods sold must be attributed to gross receipts with respect to gross DEI or gross FDDEI regardless of whether certain costs included in cost of goods sold can be associated with activities undertaken in an earlier taxable year (including a year before the effective date of section 250). A domestic corporation or partnership may not segregate cost of goods sold with respect to a particular product into component costs and attribute those component costs disproportionately to gross receipts with respect to amounts excluded from gross DEI or gross FDDEI, as applicable.

(2) *Deductions properly allocable to gross DEI and gross FDDEI*—(i) *In general.* For purposes of determining a domestic corporation's deductions that are properly allocable to gross DEI and gross FDDEI, the corporation's deductions are allocated and apportioned to gross DEI and gross FDDEI under the rules of §§ 1.861–8 through 1.861–14T and 1.861–17 by treating section 250(b) as an operative section described in § 1.861–8(f). In allocating and apportioning deductions under §§ 1.861–8 through 1.861–14T and 1.861–17, gross FDDEI and gross RDEI are treated as separate statutory groupings. The deductions allocated and apportioned to gross DEI equal the sum of the deductions allocated and apportioned to gross FDDEI and gross RDEI. All items of gross income described in paragraphs (c)(15)(i) through (vi) of this section are in the residual grouping.

(ii) *Determination of deductions to allocate.* For purposes of determining the deductions of a domestic corporation for a taxable year properly allocable to gross DEI and gross FDDEI, the deductions of the corporation for the taxable year are determined without regard to sections 163(j), 170(b)(2), 172, 246(b), and 250.

(3) *Examples.* The following examples illustrate the application of this paragraph (d).

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation that is not a member of a consolidated group.

(B) All sales and services are provided to persons that are not related parties.

(C) All sales and services to foreign persons qualify as FDDEI transactions.

(ii) *Examples*—

(A) *Example 1: Allocation of deductions*—(*1*) *Facts*. For a taxable year, DC manufactures products A and B in the United States. DC sells products A and B and provides services associated with products A and B to United States and foreign persons. DC's QBAI for the taxable year is $1,000x. DC has $300x of deductible interest expense allowed under section 163. DC has assets with a tax book value of $2,500x. The tax book value of DC's assets used to produce products A and B and services is split evenly between assets that produce gross FDDEI and assets that produce gross RDEI. DC has $840x of supportive deductions, as defined in §1.861–8(b)(3), attributable to general and administrative expenses incurred for the purpose of generating the class of gross income that consists of gross DEI. DC apportions the $840x of deductions on the basis of gross income in accordance with §1.861–8T(c)(1). For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, DC attributes $200x of cost of goods sold to Product A and $400x of cost of goods sold to Product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of such product sold to foreign persons and the gross receipts of such product sold to United States persons. The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

TABLE 1 TO PARAGRAPH (d)(3)(ii)(A)(*1*)

	Product A	Product B	Services	Total
Gross receipts from U.S. persons	$200x	$800x	$100x	$1,100x
Gross receipts from foreign persons	200x	800x	100x	1,100x
Total gross receipts	400x	1,600x	200x	2,200x
Cost of goods sold for gross receipts from U.S. persons	100x	200x	0	300x
Cost of goods sold for gross receipts from foreign persons	100x	200x	0	300x
Total cost of goods sold	200x	400x	0	600x
Gross income	200x	1,200x	200x	1,600x
Tax book value of assets used to produce products/services	500x	500x	1,500x	2,500x

(*2*) *Analysis*—(*i*) *Determination of gross FDDEI and gross RDEI*. Because DC does not have any income described in section 250(b)(3)(A)(i)(I) through (VI) and paragraphs (c)(15)(i) through (vi) of this section, none of its gross income is excluded from gross DEI. DC's gross DEI is $1,600x ($2,200x total gross receipts less $600x total cost of goods sold). DC's gross FDDEI is $800x ($1,100x of gross receipts from foreign persons minus attributable cost of goods sold of $300x).

(*ii*) *Determination of foreign-derived deduction eligible income*. To calculate its FDDEI, DC must determine the amount of its deductions that are allocated and apportioned to gross FDDEI and then subtract those amounts from gross FDDEI. DC's interest deduction of $300x is allocated and apportioned to gross FDDEI on the basis of the average total value of DC's assets in each grouping. DC has assets with a tax book value of $2,500x split evenly between assets that produce gross FDDEI and assets that produce gross RDEI. Accordingly, an interest expense deduction of $150x is apportioned to DC's gross FDDEI. With respect to DC's supportive deductions of $840x that are related to DC's gross DEI, DC apportions such deductions between gross FDDEI and gross RDEI on the basis of gross income. Accordingly, supportive deductions of $420x are apportioned to DC's gross FDDEI. Thus, DC's FDDEI is $230x, which is equal to its gross FDDEI of $800x less $150x of interest expense deduction and $420x of supportive deductions.

(*iii*) *Determination of deemed intangible income*. DC's deemed tangible income return is $100x, which is equal to 10 percent of its QBAI of $1,000x. DC's DEI is $460x, which is equal to its gross DEI of $1,600x less $300x of interest expense deductions and $840x of supportive deductions. Therefore, DC's deemed intangible income is $360x, which is equal to the excess of its DEI of $460x over its deemed tangible income return of $100x.

(*iv*) *Determination of foreign-derived intangible income.* DC's foreign-derived ratio is 50 percent, which is the ratio of DC's FDDEI of $230x to DC's DEI of $460x. Therefore, DC's FDII is $180x, which is equal to DC's deemed intangible income of $360x multiplied by its foreign-derived ratio of 50 percent.

(B) *Example 2: Allocation of deductions with respect to a partnership*—(*1*) *Facts*—(*i*) *DC's operations.* DC is engaged in the production and sale of products consisting of two separate product groups in three-digit Standard Industrial Classification (SIC) Industry Groups, hereafter referred to as Group AAA and Group BBB. All of the gross income of DC is included in gross DEI. DC incurs $250x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, DC attributes $210x of cost of goods sold to Group AAA products and $900x of cost of goods sold to Group BBB products, and then attributes the cost of goods sold with respect to each such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which DC attributes the cost of goods sold is a reasonable method. For the taxable year, DC has the following income tax items relevant to the determination of its FDII:

TABLE 2 TO (d)(3)(ii)(B)(*1*)(*i*)

	Group AAA products	Group BBB products	Total
Gross receipts from U.S. persons	$200x	$800x	$1,000x
Gross receipts from foreign persons	100x	400x	500x
Total gross receipts	300x	1,200x	1,500x
Cost of goods sold for gross receipts from U.S. persons	140x	600x	740x
Cost of goods sold for gross receipts from foreign persons	70x	300x	370x
Total cost of goods sold	210x	900x	1,110x
Gross income	90x	300x	390x
R&E deductions	40x	210x	250x

(*ii*) *PRS's operations.* In addition to its own operations, DC is a partner in PRS, a partnership that also produces products described in SIC Group AAA. DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. During the taxable year, PRS sells Group AAA products solely to foreign persons, and all of its gross income is included in gross DEI. PRS has $400 of gross receipts from sales of Group AAA products for the taxable year and incurs $100x of research and experimental (R&E) expenditures in the United States that are deductible under section 174. None of the R&E is included in cost of goods sold. For purposes of determining gross FDDEI and gross DEI under paragraph (d)(1) of this section, PRS attributes $200x of cost of goods sold to Group AAA products, and then attributes the cost of goods sold with respect to such product group ratably between the gross receipts with respect to such product group sold to foreign persons and the gross receipts with respect to such product group not sold to foreign persons. The manner in which PRS attributes the cost of goods sold is a reasonable method. DC's distributive share of PRS taxable items is $100x of gross income and $50x of R&E deductions, and DC's share of PRS's gross receipts from sales of Group AAA products for the taxable year is $200x under § 1.861–17(f)(3).

(*iii*) *Application of the sales method to allocate and apportion R&E.* DC applies the sales method to apportion its R&E deductions under § 1.861–17. Neither DC nor PRS licenses or sells its intangible property to controlled or uncontrolled corporations in a manner that necessitates including the sales by such corporations for purposes of apportioning DC's R&E deductions.

(*2*) *Analysis*—(*i*) *Determination of gross DEI and gross FDDEI.* Under paragraph (e)(1) of this section, DC's gross DEI, gross FDDEI, and deductions allocable to those amounts include its distributive share of gross DEI, gross FDDEI, and deductions of PRS. Thus, DC's gross DEI for the year is $490x ($390x attributable to DC and $100x attributable to DC's interest in PRS). DC's gross income from sales of Group AAA products to foreign persons is $30x ($100x of gross receipts minus attributable cost of goods sold of $70x). DC's gross income from sales of Group BBB products to foreign persons is $100x ($400x of gross receipts minus attributable cost of goods sold of $300x). DC's gross FDDEI for the year is $230x ($30x from DC's sale of Group AAA products plus $100x from DC's sale of Group BBB products plus DC's distributive share of PRS's gross FDDEI of $100x).

(*ii*) *Allocation and apportionment of R&E deductions*. To determine FDDEI, DC must allocate and apportion its R&E expense of $300x ($250x incurred directly by DC and $50x incurred indirectly through DC's interest in PRS). In accordance with §1.861–17, R&E expenses are first allocated to a class of gross income related to a three-digit SIC group code. DC's R&E expenses related to products in Group AAA are $90x ($40x incurred directly by DC and $50x incurred indirectly through DC's interest in PRS) and its expenses related to Group BBB are $210x. See paragraph (d)(2)(i) of this section. Accordingly, all R&E expense attributable to a particular SIC group code is apportioned on the basis of the amounts of sales within that SIC group code. Total sales within Group AAA were $500x ($300x directly by DC and $200x attributable to DC's interest in PRS), $300x of which were made to foreign persons ($100x directly by DC and $200x attributable to DC's interest in PRS). Therefore, the $90x of R&E expense related to Group AAA is apportioned $54x to gross FDDEI ($90x × $300x/$500x) and $36x to gross RDEI ($90x × $200x/$500x). Total sales within Group BBB were $1,200x, $400x of which were made to foreign persons. Therefore, the $210x of R&E expense related to products in Group BBB is apportioned $70x to gross FDDEI ($210x × $400x/$1,200x) and $140x to gross RDEI ($210x × $800x/$1,200x). Accordingly, DC's FDDEI for the tax year is $106x ($230x gross FDDEI minus $124x of R&E ($54x + $70x) allocated and apportioned to gross FDDEI).

(e) *Domestic corporate partners*—(1) *In general*. A domestic corporation's DEI and FDDEI for a taxable year are determined by taking into account the corporation's share of gross DEI, gross FDDEI, and deductions of any partnership (whether domestic or foreign) in which the corporation is a direct or indirect partner. For purposes of the preceding sentence, a domestic corporation's share of each such item of a partnership is determined in accordance with the corporation's distributive share of the underlying items of income, gain, deduction, and loss of the partnership that comprise such amounts. See §1.250(b)–2(g) for rules on calculating the increase to a domestic corporation's QBAI by the corporation's share of partnership QBAI.

(2) *Reporting requirement for partnership with domestic corporate partners*. A partnership that has one or more direct partners that are domestic corporations and that is required to file a return under section 6031 must furnish to each such partner on or with such partner's Schedule K–1 (Form 1065 or any successor form) by the due date (including extensions) for furnishing Schedule K–1 the partner's share of the partnership's gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI and gross FDDEI, and partnership QBAI (as determined under §1.250(b)–2(g)) for each taxable year in which the partnership has gross DEI, gross FDDEI, deductions that are properly allocable to the partnership's gross DEI or gross FDDEI, or partnership specified tangible property (as defined in §1.250(b)–2(g)(5)). In the case of tiered partnerships where one or more partners of an upper-tier partnership are domestic corporations, a lower-tier partnership must report the amount specified in this paragraph (e)(2) to the upper-tier partnership to allow reporting of such information to any partner that is a domestic corporation. To the extent that a partnership cannot determine the information described in the first sentence of this paragraph (e)(2), the partnership must instead furnish to

each partner its share of the partnership's attributes that a partner needs to determine the partner's gross DEI, gross FDDEI, deductions that are properly allocable to the partner's gross DEI and gross FDDEI, and the partner's adjusted bases in partnership specified tangible property.

(3) *Examples.* The following examples illustrate the application of this paragraph (e).

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC, a domestic corporation, is a partner in PRS, a partnership.

(B) FP and FP2 are foreign persons.

(C) FC is a foreign corporation.

(D) The allocations under PRS's partnership agreement satisfy the requirements of section 704.

(E) No partner of PRS is a related party of DC.

(F) DC, PRS, and FC all use the calendar year as their taxable year.

(G) PRS has no items of income, loss, or deduction for its taxable year, except the items of income described.

(ii) *Examples—*

(A) *Example 1: Sale by partnership to foreign person—*(*1*) *Facts.* Under the terms of the partnership agreement, DC is allocated 50 percent of all income, gain, loss, and deductions of PRS. For the taxable year, PRS recognizes $20x of gross income on the sale of general property (as defined in §1.250(b)–3(b)(10)) to FP, a foreign person (as determined under §1.250(b)–4(c)), for a foreign use (as determined under §1.250(b)–4(d)). The gross income recognized on the sale of property is not described in section 250(b)(3)(A)(I) through (VI) or paragraphs (c)(15)(i) through (vi) of this section.

(*2*) *Analysis.* PRS's sale of property to FP is a FDDEI sale as described in §1.250(b)–4(b). Therefore, the gross income derived from the sale ($20x) is included in PRS's gross DEI and gross FDDEI, and DC's share of PRS's gross DEI and gross FDDEI ($10x) is included in DC's gross DEI and gross FDDEI for the taxable year.

(B) *Example 2: Sale by partnership to foreign person attributable to foreign branch—*(*1*) *Facts.* The facts are the same as in paragraph (e)(3)(ii)(A)(*1*) of this section (the facts in *Example 1*), except the income from the sale of property to FP is attributable to a foreign branch of PRS.

(*2*) *Analysis.* PRS's sale of property to FP is excluded from PRS's gross DEI under section 250(b)(3)(A)(VI) and paragraph (c)(15)(vi) of this section. Accordingly, DC's share of PRS's gross income of $10x from the sale is not included in DC's gross DEI or gross FDDEI for the taxable year.

(C) *Example 3: Partnership with a loss in gross FDDEI—*(*1*) *Facts.* The facts are the same as in paragraph (e)(3)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that in the same taxable year, PRS also sells property to FP2, a foreign person (as determined under §1.250(b)–4(c)), for a foreign use (as determined under §1.250(b)–4(d)). After taking into account both sales, PRS has a gross loss of $30x.

(*2*) *Analysis.* Both the sale of property to FP and the sale of property to FP2 are FDDEI sales because each sale is described in §1.250(b)–4(b). DC's share of PRS's gross loss ($15x) from the sales is included in DC's gross DEI and gross FDDEI.

(D) *Example 4: Sale by partnership to foreign related party of the partnership—*(*1*) *Facts.* Under the terms of the partnership agreement, DC has 25 percent of the capital and profits interest in the partnership and is allocated 25 percent of all income, gain, loss, and deductions of PRS. PRS owns 100 percent of the single class of stock of FC. In the taxable year, PRS has $20x of gain on the sale of general property (as defined in §1.250(b)–3(b)(10)) to FC, and FC makes a physical and material change to the property within the meaning of §1.250(b)–4(d)(1)(iii)(B) outside the United States before selling the property to customers in the United States.

(*2*) *Analysis.* The sale of property by PRS to FC is described in §1.250(b)–4(b) without regard to the application of §1.250(b)–6, since the sale is to a foreign person (as determined under §1.250(b)–4(c)) for a foreign use (as determined under §1.250(b)–4(d)). However, FC is a foreign related party of PRS within the meaning of section 250(b)(5)(D) and §1.250(b)–3(b)(6), because FC and PRS are members of a modified affiliated group within the meaning of paragraph (c)(17) of this section. Therefore, the sale by PRS to FC is a related party sale within the meaning of §1.250(b)–6(b)(1). Under section 250(b)(5)(C)(i) and §1.250(b)–6(c), because FC did not sell the property, or use the property in connection with other property sold or the provision of a service, to a foreign unrelated party before the property was subject to a domestic use, the sale by PRS to FC is not a FDDEI sale. See §1.250(b)–6(c)(1). Accordingly, the gain from the sale ($20x) is included in PRS's gross DEI but not its gross FDDEI, and DC's share of PRS's gain ($5x) is included in DC's gross DEI but not gross FDDEI. This is the result notwithstanding that FC is not a related party of DC because FC and DC are not members of a modified affiliated group within the meaning of paragraph (c)(17) of this section.

(f) *Determination of FDII for consolidated groups.* A member of a consolidated group (as defined in §1.1502–1(h)) determines its FDII under the rules provided in §1.1502–50.

(g) *Determination of FDII for tax-exempt corporations.* The FDII of a corporation that is subject to the unrelated business income tax under section 511 is determined only by reference to that corporation's items of income, gain, deduction, or loss, and adjusted bases in property, that are taken into account in computing the corporation's unrelated business taxable income (as defined in section 512). For example, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property used in the production of both unrelated business income and gross income that is not unrelated business income, only the portion of the basis of such property taken into account in computing the corporation's unrelated business taxable income is taken into account in determining the corporation's QBAI. Similarly, if a corporation that is subject to the unrelated business income tax under section 511 has tangible property that is used in both the production of gross DEI and the production of gross income that is not gross DEI, only the corporation's unrelated business income is taken into account in determining the corporation's dual use ratio with respect to such property under §1.250(b)–2(d)(3).

[T.D. 9901, 85 FR 43080, July 15, 2020, as amended by T.D. 9959, 87 FR 324, Jan. 4, 2022]

§ 1.250(b)–2 Qualified business asset investment (QBAI).

(a) *Scope.* This section provides general rules for determining the qualified business asset investment of a domestic corporation for purposes of determining its deemed tangible income return under §1.250(b)–1(c)(4). Paragraph (b) of this section defines qualified business asset investment (QBAI). Paragraph (c) of this section defines tangible property and specified tangible property. Paragraph (d) of this section provides rules for determining the portion of property that is specified tangible property when the property is used in the production of both gross DEI and gross income that is not gross DEI. Paragraph (e) of this section provides rules for determining the adjusted basis of specified tangible property. Paragraph (f) of this section provides rules for determining QBAI of a domestic corporation with a short taxable year. Paragraph (g) of this section provides rules for increasing the QBAI of a domestic corporation by reason of property owned through a partnership. Paragraph (h) of this section provides an anti-avoidance rule that disregards certain transfers when determining the QBAI of a domestic corporation.

(b) *Definition of qualified business asset investment.* The term *qualified business asset investment (QBAI)* means the average of a domestic corporation's aggregate adjusted bases as of the close of each quarter of the domestic corporation's taxable year in specified tangible property that is used in a trade or business of the domestic corporation and is of a type with respect to which a deduction is allowable under section 167. In the case of partially depreciable property, only the depreciable portion of the property is of a type with respect to which a deduction is allowable under section 167.

(c) *Specified tangible property*—(1) *In general.* The term *specified tangible property* means, with respect to a domestic corporation for a taxable year, tangible property of the domestic corporation used in the production of gross DEI for the taxable year. For purposes of the preceding sentence, tangible property of a domestic corporation is used in the production of gross DEI for a taxable year if some or all of the depreciation or cost recovery allowance with respect to the tangible property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under § 1.250(b)–1(d)(2) or capitalized to inventory or other property held for sale, some or all of the gross income or loss from the sale of which is taken into account in determining DEI of the domestic corporation for the taxable year.

(2) *Tangible property*. The term *tangible property* means property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 without regard to section 168(f)(1), (2), or (5), section 168(k)(2)(A)(i)(II), (IV), or (V), and the date placed in service.

(d) *Dual use property*—(1) *In general*. The amount of the adjusted basis in dual use property of a domestic corporation for a taxable year that is treated as adjusted basis in specified tangible property for the taxable year is the average of the domestic corporation's adjusted basis in the property multiplied by the dual use ratio with respect to the property for the taxable year.

(2) *Definition of dual use property*. The term *dual use property* means, with respect to a domestic corporation and a taxable year, specified tangible property of the domestic corporation that is used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year. For purposes of the preceding sentence, specified tangible property of a domestic corporation is used in the production of gross DEI and the production of gross income that is not gross DEI for a taxable year if less than all of the depreciation or cost recovery allowance with respect to the property is either allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under § 1.250(b)–1(d)(2) or capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year.

(3) *Dual use ratio*. The term *dual use ratio* means, with respect to dual use property, a domestic corporation, and a taxable year, a ratio (expressed as a percentage) calculated as—

(i) The sum of—

(A) The depreciation deduction or cost recovery allowance with respect to the property that is allocated and apportioned to the gross DEI of the domestic corporation for the taxable year under § 1.250(b)–1(d)(2); and

(B) The depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the DEI of the domestic corporation for the taxable year; divided by

(ii) The sum of—

(A) The total amount of the domestic corporation's depreciation deduction or cost recovery allowance with respect to the property for the taxable year; and

(B) The total amount of the domestic corporation's depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the income or loss of the domestic corporation for the taxable year.

(4) *Example*. The following example illustrates the application of this paragraph (d).

(i) *Facts*. DC, a domestic corporation, owns a machine that produces both gross DEI and income that is not gross DEI. The average adjusted basis of the machine for the taxable year in the hands of DC is $4,000x. The depreciation with respect to the machine for the taxable year is $400x, $320x of which is capitalized to inventory of Product A, gross income or loss from the sale of which is taken into account in determining DC's gross DEI for the taxable year, and $80x of which is capitalized to inventory of Product B, gross income or loss from the sale of which is not taken into account in determining DC's gross DEI for the taxable year. DC also owns an office building for its administrative functions with an average adjusted basis for the taxable year of

$10,000x. DC does not capitalize depreciation with respect to the office building to inventory or other property held for sale. DC's depreciation deduction with respect to the office building is $1,000x for the taxable year, $750x of which is allocated and apportioned to gross DEI under §1.250(b)–1(d)(2), and $250x of which is allocated and apportioned to income other than gross DEI under §1.250(b)–1(d)(2).

(ii) *Analysis*—(A) *Dual use property*. The machine and office building are property for which the depreciation deduction provided by section 167(a) is eligible to be determined under section 168 (without regard to section 168(f)(1), (2), or (5), section 168(k)(2)(A)(i)(II), (IV), or (V), and the date placed in service). Therefore, under paragraph (c)(2) of this section, the machine and office building are tangible property. Furthermore, because the machine and office building are used in the production of gross DEI for the taxable year within the meaning of paragraph (c)(1) of this section, the machine and office building are specified tangible property. Finally, because the machine and office building are used in both the production of gross DEI and the production of gross income that is not gross DEI for the taxable year within the meaning of paragraph (d)(2) of this section, the machine and office building are dual use property. Therefore, under paragraph (d)(1) of this section, the amount of DC's adjusted basis in the machine and office building that is treated as adjusted basis in specified tangible property for the taxable year is determined by multiplying DC's adjusted basis in the machine and office building by DC's dual use ratio with respect to the machine and office building determined under paragraph (d)(3) of this section.

(B) *Depreciation not capitalized to inventory*. Because none of the depreciation with respect to the office building is capitalized to inventory or other property held for sale, DC's dual use ratio with respect to the office building is determined entirely by reference to the depreciation deduction with respect to the office building. Therefore, under paragraph (d)(3) of this section, DC's dual use ratio with respect to the office building for Year 1 is 75 percent, which is DC's depreciation deduction with respect to the office building that is allocated and apportioned to gross DEI under §1.250(b)–1(d)(2) for Year 1 ($750x), divided by the total amount of DC's depreciation deduction with respect to the office building for Year 1 ($1000x). Accordingly, under paragraph (d)(1) of this section, $7,500x ($10,000x × 0.75) of DC's average adjusted bases in the office building is taken into account under paragraph (b) of this section in determining DC's QBAI for the taxable year.

(C) *Depreciation capitalized to inventory*. Because all of the depreciation with respect to the machine is capitalized to inventory, DC's dual use ratio with respect to the machine is determined entirely by reference to the depreciation with respect to the machine that is capitalized to inventory and included in cost of goods sold. Therefore, under paragraph (d)(3) of this section, DC's dual use ratio with respect to the machine for the taxable year is 80 percent, which is DC's depreciation with respect to the machine that is capitalized to inventory of Product A, the gross income or loss from the sale of which is taken into account in determining DC's DEI for the taxable year ($320x), divided by DC's depreciation with respect to the machine that is capitalized to inventory, the gross income or loss from the sale of which is taken into account in determining DC's income for Year 1 ($400x). Accordingly, under paragraph (d)(1) of this section, $3,200x ($4,000x × 0.8) of DC's average adjusted basis in the machine is taken into account under paragraph (b) of this section in determining DC's QBAI for the taxable year.

(e) *Determination of adjusted basis of specified tangible property*—(1) *In general*. The adjusted basis in specified tangible property for purposes of this section is determined by using the cost capitalization methods of accounting used by the domestic corporation for purposes of determining the gross income and deductions of the domestic corporation and the alternative depreciation system under section 168(g), and by allocating the depreciation deduction with respect to such property for the domestic corporation's taxable year ratably to each day during the period in the taxable year to which such depreciation relates. For purposes of the preceding sentence, the period in the taxable year to which such depreciation relates is determined without regard to the applicable convention under section 168(d).

(2) *Effect of change in law.* The adjusted basis in specified tangible property is determined without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A. For purposes of applying section 250(b)(2)(B) and this paragraph (e), the technical amendment to section 168(g) (to provide a recovery period of 20 years for qualified improvement property for purposes of the alternative depreciation system) enacted in section 2307(a) of the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136 (2020) is treated as enacted on December 22, 2017.

(3) *Specified tangible property placed in service before enactment of section 250.* The adjusted basis in specified tangible property placed in service before December 22, 2017, is determined using the alternative depreciation system under section 168(g), as if this system had applied from the date that the property was placed in service.

(f) *Special rules for short taxable years*—(1) *In general.* In the case of a domestic corporation that has a taxable year that is less than twelve months (a *short taxable year*), the rules for determining the QBAI of the domestic corporation under this section are modified as provided in paragraphs (f)(2) and (3) of this section with respect to the taxable year.

(2) *Determination of when the quarter closes.* For purposes of determining when the quarter closes, in determining the QBAI of a domestic corporation for a short taxable year, the quarters of the domestic corporation for purposes of this section are the full quarters beginning and ending within the short taxable year (if any), determining quarter length as if the domestic corporation did not have a short taxable year, plus one or more short quarters (if any).

(3) *Reduction of qualified business asset investment.* The QBAI of a domestic corporation for a short taxable year is the sum of—

(i) The sum of the domestic corporation's aggregate adjusted bases in specified tangible property as of the close of each full quarter (if any) in the domestic corporation's taxable year divided by four; plus

(ii) The domestic corporation's aggregate adjusted bases in specified tangible property as of the close of each short quarter (if any) in the domestic corporation's taxable year multiplied by the sum of the number of days in each short quarter divided by 365.

(4) *Example.* The following example illustrates the application of this paragraph (f).

(i) *Facts.* A, an individual, owns all of the stock of DC, a domestic corporation. A owns DC from the beginning of the taxable year. On July 15 of the taxable year, A sells DC to USP, a domestic corporation that is unrelated to A. DC becomes a member of the consolidated group of which USP is the common parent and as a result, under §1.1502–76(b)(2)(ii), DC's taxable year is treated as ending on July 15. USP and DC both use the calendar year as their taxable year. DC's aggregate adjusted bases in specified tangible property for the taxable year are $250x as of March 31, $300x as of June 30, $275x as of July 15, $500x as of September 30, and $450x as of December 31.

(ii) *Analysis*—(A) *Determination of short taxable years and quarters.* DC has two short taxable years during the year. The first short taxable year is from January 1 to July 15, with two full quarters (January 1 through March 31 and April 1 through June 30) and one short quarter (July 1 through July 15). The second taxable year is from July 16 to December 31, with one short quarter (July 16 through September 30) and one full quarter (October 1 through December 31).

(B) *Calculation of qualified business asset investment for the first short taxable year.* Under paragraph (f)(2) of this section, for the first short taxable year, DC has three quarter closes (March 31, June 30, and July 15). Under paragraph (f)(3) of this section, the QBAI of DC for the first short taxable year is $148.80x, the sum of $137.50x (($250x + $300x)/4) attributable to the two full quarters and $11.30x ($275x × 15/365) attributable to the short quarter.

(C) *Calculation of qualified business asset investment for the second short taxable year.* Under paragraph (f)(2) of this section, for the second short taxable year, DC has two quarter closes (September 30 and December 31). Under paragraph (f)(3) of this section, the QBAI of DC for the second short taxable year is $217.98x, the sum of $112.50x ($450x/4) attributable to the one full quarter and $105.48x ($500x × 77/365) attributable to the short quarter.

(g) *Partnership property*—(1) *In general.* If a domestic corporation holds an interest in one or more partnerships during a taxable year (including indirectly through one or more partnerships that are partners in a lower-tier partnership), the QBAI of the domestic corporation for the taxable year (determined without regard to this paragraph (g)(1)) is increased by the sum of the domestic corporation's partnership QBAI with respect to each partnership for the taxable year.

(2) *Determination of partnership QBAI.* For purposes of paragraph (g)(1) of this section, the term *partnership QBAI* means, with respect to a partnership, a domestic corporation, and a taxable year, the sum of the domestic corporation's partner adjusted basis in each partnership specified tangible property of the partnership for each partnership taxable year that ends with or within the taxable year. If a partnership taxable year is less than twelve months, the principles of paragraph (f) of this section apply in determining a domestic corporation's partnership QBAI with respect to the partnership.

(3) *Determination of partner adjusted basis*—(i) *In general.* For purposes of paragraph (g)(2) of this section, the term *partner adjusted basis* means the amount described in paragraph (g)(3)(ii) of this section with respect to sole use partnership property or paragraph (g)(3)(iii) of this section with respect to dual use partnership property. The principles of section 706(d) apply to this determination.

(ii) *Sole use partnership property*—(A) *In general.* The amount described in this paragraph (g)(3)(ii), with respect to sole use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation's proportionate share of the partnership adjusted basis in the sole use partnership property for the partnership taxable year and the domestic corporation's partner-specific QBAI basis in the sole use partnership property for the partnership taxable year.

(B) *Definition of sole use partnership property.* The term *sole use partnership property* means, with respect to a partnership, a partnership taxable year, and a domestic corporation, partnership specified tangible property of the partnership that is used in the production of only gross DEI of the domestic corporation for the taxable year in which or with which the partnership taxable year ends. For purposes of the preceding sentence, partnership specified tangible property of a partnership is used in the production of only gross DEI for a taxable year if all the domestic corporation's distributive share of the partnership's depreciation deduction or cost recovery allowance with respect to the property (if any) for the partnership taxable year that ends with or within the taxable year is allocated and apportioned to the domestic corporation's gross DEI for the taxable year under §1.250(b)–1(d)(2) and, if any of the partnership's depreciation or cost recovery allowance with respect to the property is capitalized to inventory or other property held for sale, all the domestic corporation's distributive share of the partnership's gross income or loss from the sale of such inventory or other property for the partnership taxable year that ends with or within the taxable year is taken into account in determining the DEI of the domestic corporation for the taxable year.

(iii) *Dual use partnership property*—(A) *In general.* The amount described in this paragraph (g)(3)(iii), with respect to dual use partnership property, a partnership taxable year, and a domestic corporation, is the sum of the domestic corporation's proportionate share of the partnership adjusted basis in the property for the partnership taxable year and the domestic corporation's partner-specific QBAI basis in the property for the partnership taxable year, multiplied by the domestic corporation's dual use ratio with respect to the property for the partnership taxable year determined under the principles of paragraph (d)(3) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to the domestic corporation's distributive share of the amounts described in paragraph (d)(3) of this section.

(B) *Definition of dual use partnership property*. The term *dual use partnership property* means partnership specified tangible property other than sole use partnership property.

(4) *Determination of proportionate share of the partnership's adjusted basis in partnership specified tangible property*—(i) *In general*. For purposes of paragraph (g)(3) of this section, the domestic corporation's proportionate share of the partnership adjusted basis in partnership specified tangible property for a partnership taxable year is the partnership adjusted basis in the property multiplied by the domestic corporation's proportionate share ratio with respect to the property for the partnership taxable year. Solely for purposes of determining the proportionate share ratio under paragraph (g)(4)(ii) of this section, the partnership's calculation of, and a partner's distributive share of, any income, loss, depreciation, or cost recovery allowance is determined under section 704(b).

(ii) *Proportionate share ratio*. The term *proportionate share ratio* means, with respect to a partnership, a partnership taxable year, and a domestic corporation, the ratio (expressed as a percentage) calculated as—

(A) The sum of—

(*1*) The domestic corporation's distributive share of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(*2*) The amount of the partnership's depreciation or cost recovery allowance with respect to the property that is capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the domestic corporation's distributive share of the partnership's income or loss for the partnership taxable year; divided by

(B) The sum of—

(*1*) The total amount of the partnership's depreciation deduction or cost recovery allowance with respect to the property for the partnership taxable year; and

(*2*) The total amount of the partnership's depreciation or cost recovery allowance with respect to the property capitalized to inventory or other property held for sale, the gross income or loss from the sale of which is taken into account in determining the partnership's income or loss for the partnership taxable year.

(5) *Definition of partnership specified tangible property*. The term *partnership specified tangible property* means, with respect to a domestic corporation, tangible property (as defined in paragraph (c)(2) of this section) of a partnership that is—

(i) Used in the trade or business of the partnership;

(ii) Of a type with respect to which a deduction is allowable under section 167; and

(iii) Used in the production of gross income included in the domestic corporation's gross DEI.

(6) *Determination of partnership adjusted basis*. For purposes of this paragraph (g), the term *partnership adjusted basis* means, with respect to a partnership, partnership specified tangible property, and a partnership taxable year, the amount equal to the average of the partnership's adjusted basis in the partnership specified tangible property as of the close of each quarter in the partnership taxable year determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)(B) or section 734(b)(2)(B) that are attributable to distributions of tangible property (as defined in paragraph (c)(2) of this section) and for adjustments under section 734(b)(1)(A) or 734(b)(2)(A). The principles of paragraphs (e) and (h) of this section apply for purposes of determining a partnership's adjusted basis in partnership specified tangible property and the proportionate share of the partnership's adjusted basis in partnership specified tangible property.

(7) *Determination of partner-specific QBAI basis.* For purposes of this paragraph (g), the term *partner-specific QBAI basis* means, with respect to a domestic corporation, a partnership, and partnership specified tangible property, the amount that is equal to the average of the basis adjustment under section 743(b) that is allocated to the partnership specified tangible property of the partnership with respect to the domestic corporation as of the close of each quarter in the partnership taxable year. For this purpose, a negative basis adjustment under section 743(b) is expressed as a negative number. The principles of paragraphs (e) and (h) of this section apply for purposes of determining the partner-specific QBAI basis with respect to partnership specified tangible property.

(8) *Examples.* The following examples illustrate the rules of this paragraph (g).

(i) *Assumed facts.* Except as otherwise stated, the following facts are assumed for purposes of the examples:

(A) DC, DC1, DC2, and DC3 are domestic corporations.

(B) PRS is a partnership and its allocations satisfy the requirements of section 704.

(C) All properties are partnership specified tangible property.

(D) All persons use the calendar year as their taxable year.

(E) There is no partner-specific QBAI basis with respect to any property.

(ii) *Example 1: Sole use partnership property*—(A) *Facts.* DC is a partner in PRS. PRS owns two properties, Asset A and Asset B. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset A is $100x and in Asset B is $500x. In Year 1, PRS's section 704(b) depreciation deduction is $10x with respect to Asset A and $5x with respect to Asset B, and DC's section 704(b) distributive share of the depreciation deduction is $8x with respect to Asset A and $1x with respect to Asset B. None of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale. DC's entire distributive share of the depreciation deduction with respect to Asset A and Asset B is allocated and apportioned to DC's gross DEI for Year 1 under § 1.250(b)–1(d)(2).

(B) *Analysis*—(*1*) *Sole use partnership property.* Because all of DC's distributive share of the depreciation deduction with respect to Asset A and B is allocated and apportioned to gross DEI for Year 1, Asset A and Asset B are sole use partnership property within the meaning of paragraph (g)(3)(ii)(B) of this section. Therefore, under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A and Asset B is equal to the sum of DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B for Year 1 and DC's partner-specific QBAI basis in Asset A and Asset B for Year 1, respectively.

(*2*) *Proportionate share.* Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A and Asset B is PRS's partnership adjusted basis in Asset A and Asset B for Year 1, multiplied by DC's proportionate share ratio with respect to Asset A and Asset B for Year 1, respectively. Because none of the depreciation with respect to Asset A or Asset B is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset A and Asset B is determined entirely by reference to the depreciation deduction with respect to Asset A and Asset B. Therefore, DC's proportionate share ratio with respect to Asset A for Year 1 is 80 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($8x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset A for Year 1 ($10x). DC's proportionate share ratio with respect to Asset B for Year 1 is 20 percent, which is the ratio of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($1x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset B for Year 1 ($5x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset A is

$80x ($100x × 0.8), and DC's proportionate share of PRS's partnership adjusted basis in Asset B is $100x ($500x × 0.2).

(*3*) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset A and Asset B, DC's partner adjusted basis in Asset A and Asset B is determined entirely by reference to its proportionate share of PRS's partnership adjusted basis in Asset A and Asset B. Therefore, under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A is $80x, DC's proportionate share of PRS's partnership adjusted basis in Asset A, and DC's partner adjusted basis in Asset B is $100x, DC's proportionate share of PRS's partnership adjusted basis in Asset B.

(*4*) *Partnership QBAI.* Under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is $180x, the sum of DC's partner adjusted basis in Asset A ($80x) and DC's partner adjusted basis in Asset B ($100x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by $180x.

(iii) *Example 2: Dual use partnership property*—(A) *Facts.* DC owns a 50 percent interest in PRS. All section 704(b) and tax items are identical and are allocated equally between DC and its other partner. PRS owns three properties, Asset C, Asset D, and Asset E. PRS sells two products, Product A and Product B. All of DC's distributive share of the gross income or loss from the sale of Product A is taken into account in determining DC's DEI, and none of DC's distributive share of the gross income or loss from the sale of Product B is taken into account in determining DC's DEI.

(*1*) *Asset C.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset C is $100x. In Year 1, PRS's depreciation is $10x with respect to Asset C, none of which is capitalized to inventory or other property held for sale. DC's distributive share of the depreciation deduction with respect to Asset C is $5x ($10x × 0.5), $3x of which is allocated and apportioned to DC's gross DEI under §1.250(b)–1(d)(2).

(*2*) *Asset D.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset D is $500x. In Year 1, PRS's depreciation is $50x with respect to Asset D, $10x of which is capitalized to inventory of Product A and $40x is capitalized to inventory of Product B. None of the $10x depreciation with respect to Asset D capitalized to inventory of Product A is capitalized to ending inventory. However, of the $40x capitalized to inventory of Product B, $10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset D capitalized to inventory of Product A that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is $5x ($10x × 0.5), and the amount of depreciation with respect to Asset D capitalized to inventory of Product B that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is $15x ($30x × 0.5).

(*3*) *Asset E.* The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset E is $600x. In Year 1, PRS's depreciation is $60x with respect to Asset E. Of the $60x depreciation with respect to Asset E, $20x is allowed as a deduction, $24x is capitalized to inventory of Product A, and $16x is capitalized to inventory of Product B. DC's distributive share of the depreciation deduction with respect to Asset E is $10x ($20x × 0.5), $8x of which is allocated and apportioned to DC's gross DEI under §1.250(b)–1(d)(2). None of the $24x depreciation with respect to Asset E capitalized to inventory of Product A is capitalized to ending inventory. However, of the $16x depreciation with respect to Asset E capitalized to inventory of Product B, $10x is capitalized to ending inventory. Therefore, the amount of depreciation with respect to Asset E capitalized to inventory of Product A that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is $12x ($24x × 0.5), and the amount of depreciation with respect to Asset E capitalized to inventory of Product B that is taken into account in determining DC's distributive share of the income or loss of PRS for Year 1 is $3x ($6x × 0.5).

(B) *Analysis*. Because Asset C, Asset D, and Asset E are not used in the production of only gross DEI in Year 1 within the meaning of paragraph (g)(3)(ii)(B) of this section, Asset C, Asset D, and Asset E are dual use partnership property within the meaning of paragraph (g)(3)(iii)(B) of this section. Therefore, under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset C, Asset D, and Asset E is the sum of DC's proportionate share of PRS's partnership adjusted basis in Asset C, Asset D, and Asset E, respectively, for Year 1, and DC's partner-specific QBAI basis in Asset C, Asset D, and Asset E, respectively, for Year 1, multiplied by DC's dual use ratio with respect to Asset C, Asset D, and Asset E, respectively, for Year 1, determined under the principles of paragraph (d)(3) of this section, except that the ratio described in paragraph (d)(3) of this section is determined by reference to DC's distributive share of the amounts described in paragraph (d)(3) of this section.

(*1*) *Asset C*—(*i*) *Proportionate share*. Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset C is PRS's partnership adjusted basis in Asset C for Year 1, multiplied by DC's proportionate share ratio with respect to Asset C for Year 1. Because none of the depreciation with respect to Asset C is capitalized to inventory or other property held for sale, DC's proportionate share ratio with respect to Asset C is determined entirely by reference to the depreciation deduction with respect to Asset C. Therefore, DC's proportionate share ratio with respect to Asset C is 50 percent, which is the ratio calculated as the amount of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset C for Year 1 ($5x), divided by the total amount of PRS's section 704(b) depreciation deduction with respect to Asset C for Year 1 ($10x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset C is $50x ($100x × 0.5).

(*ii*) *Dual use ratio*. Because none of the depreciation with respect to Asset C is capitalized to inventory or other property held for sale, DC's dual use ratio with respect to Asset C is determined entirely by reference to the depreciation deduction with respect to Asset C. Therefore, DC's dual use ratio with respect to Asset C is 60 percent, which is the ratio calculated as the amount of DC's distributive share of PRS's depreciation deduction with respect to Asset C that is allocated and apportioned to DC's gross DEI under §1.250(b)–1(d)(2) for Year 1 ($3x), divided by the total amount of DC's distributive share of PRS's depreciation deduction with respect to Asset C for Year 1 ($5x).

(*iii*) *Partner adjusted basis*. Because DC has no partner-specific QBAI basis with respect to Asset C, DC's partner adjusted basis in Asset C is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset C, multiplied by DC's dual use ratio with respect to Asset C. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset C is $30x, DC's proportionate share of PRS's partnership adjusted basis in Asset C for Year 1 ($50x), multiplied by DC's dual use ratio with respect to Asset C for Year 1 (60 percent).

(*2*) *Asset D*—(*i*) *Proportionate share*. Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset D is PRS's partnership adjusted basis in Asset D for Year 1, multiplied by DC's proportionate share ratio with respect to Asset D for Year 1. Because all of the depreciation with respect to Asset D is capitalized to inventory, DC's proportionate share ratio with respect to Asset D is determined entirely by reference to the depreciation with respect to Asset D that is capitalized to inventory and included in cost of goods sold. Therefore, DC's proportionate share ratio with respect to Asset D is 50 percent, which is the ratio calculated as the amount of PRS's section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining DC's section 704(b) distributive share of PRS's income or loss for Year 1 ($20x), divided by the total amount of PRS's section 704(b) depreciation with respect to Asset D capitalized to Product A and Product B that is taken into account in determining PRS's section 704(b) income or loss for Year 1 ($40x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset D is $250x ($500x × 0.5).

(*ii*) *Dual use ratio*. Because all of the depreciation with respect to Asset D is capitalized to inventory, DC's dual use ratio with respect to Asset D is determined entirely by reference to the depreciation with respect to Asset D that is capitalized to inventory and included in cost of goods sold. Therefore, DC's dual use ratio with respect to Asset D is 25 percent, which is the ratio calculated as the amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC's DEI for Year 1 ($5x), divided by the total amount of depreciation with respect to Asset D capitalized to inventory of Product A and Product B that is taken into account in determining DC's income or loss for Year 1 ($20x).

(*iii*) *Partner adjusted basis*. Because DC has no partner-specific QBAI basis with respect to Asset D, DC's partner adjusted basis in Asset D is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset D, multiplied by DC's dual use ratio with respect to Asset D. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset D is $62.50x, DC's proportionate share of PRS's partnership adjusted basis in Asset D for Year 1 ($250x), multiplied by DC's dual use ratio with respect to Asset D for Year 1 (25 percent).

(*3*) *Asset E*—(*i*) *Proportionate share*. Under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset E is PRS's partnership adjusted basis in Asset E for Year 1, multiplied by DC's proportionate share ratio with respect to Asset E for Year 1. Because the depreciation with respect to Asset E is partly deducted and partly capitalized to inventory, DC's proportionate share ratio with respect to Asset E is determined by reference to both the depreciation that is deducted and the depreciation that is capitalized to inventory and included in cost of goods sold. Therefore, DC's proportionate share ratio with respect to Asset E is 50 percent, which is the ratio calculated as the sum ($25x) of the amount of DC's section 704(b) distributive share of PRS's section 704(b) depreciation deduction with respect to Asset E for Year 1 ($10x) and the amount of PRS's section 704(b) depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's section 704(b) distributive share of PRS's income or loss for Year 1 ($15x), divided by the sum ($50x) of the total amount of PRS's section 704(b) depreciation deduction with respect to Asset E for Year 1 ($20x) and the total amount of PRS's section 704(b) depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining PRS's section 704(b) income or loss for Year 1 ($30x). Accordingly, under paragraph (g)(4)(i) of this section, DC's proportionate share of PRS's partnership adjusted basis in Asset E is $300x ($600x × 0.5).

(*ii*) *Dual use ratio*. Because the depreciation with respect to Asset E is partly deducted and partly capitalized to inventory, DC's dual use ratio with respect to Asset E is determined by reference to the depreciation that is deducted and the depreciation that is capitalized to inventory and included in cost of goods sold. Therefore, DC's dual use ratio with respect to Asset E is 80 percent, which is the ratio calculated as the sum ($20x) of the amount of DC's distributive share of PRS's depreciation deduction with respect to Asset E that is allocated and apportioned to DC's gross DEI under § 1.250(b)–1(d)(2) for Year 1 ($8x) and the amount of depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's DEI for Year 1 ($12x), divided by the sum ($25x) of the total amount of DC's distributive share of PRS's depreciation deduction with respect to Asset E for Year 1 ($10x) and the total amount of depreciation with respect to Asset E capitalized to inventory of Product A and Product B that is taken into account in determining DC's income or loss for Year 1 ($15x).

(*iii*) *Partner adjusted basis.* Because DC has no partner-specific QBAI basis with respect to Asset E, DC's partner adjusted basis in Asset E is determined entirely by reference to DC's proportionate share of PRS's partnership adjusted basis in Asset E, multiplied by DC's dual use ratio with respect to Asset E. Under paragraph (g)(3)(iii)(A) of this section, DC's partner adjusted basis in Asset E is $240x, DC's proportionate share of PRS's partnership adjusted basis in Asset E for Year 1 ($300x), multiplied by DC's dual use ratio with respect to Asset E for Year 1 (80 percent).

(*4*) *Partnership QBAI.* Under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is $332.50x, the sum of DC's partner adjusted basis in Asset C ($30x), DC's partner adjusted basis in Asset D ($62.50x), and DC's partner adjusted basis in Asset E ($240x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by $332.50x.

(iv) *Example 3: Sole use partnership specified tangible property; section 743(b) adjustments*—(A) *Facts.* The facts are the same as in paragraph (g)(8)(ii)(A) of this section (the facts in *Example 1*), except that there is an average of $40x positive adjustment to the adjusted basis in Asset A as of the close of each quarter of PRS's taxable year with respect to DC under section 743(b) and an average of $20x negative adjustment to the adjusted basis in Asset B as of the close of each quarter of PRS's taxable year with respect to DC under section 743(b).

(B) *Analysis.* Under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset A is $120x, which is the sum of $80x (DC's proportionate share of PRS's partnership adjusted basis in Asset A as illustrated in paragraph (g)(8)(ii)(B)(*2*) of this section (the analysis in *Example 1*)) and $40x (DC's partner-specific QBAI basis in Asset A). Under paragraph (g)(3)(ii)(A) of this section, DC's partner adjusted basis in Asset B is $80x, the sum of $100x (DC's proportionate share of the partnership adjusted basis in the property as illustrated in paragraph (g)(8)(ii)(B)(*2*) of this section (the analysis in *Example 1*)) and (−$20x) (DC's partner-specific QBAI basis in Asset B). Therefore, under paragraph (g)(2) of this section, DC's partnership QBAI with respect to PRS is $200x ($120x + $80x). Accordingly, under paragraph (g)(1) of this section, DC increases its QBAI for Year 1 by $200x.

(v) *Example 4: Sale of partnership interest before close of taxable year*—(A) *Facts.* DC1 owns a 50 percent interest in PRS on January 1 of Year 1. PRS does not have an election under section 754 in effect. On July 1 of Year 1, DC1 sells its entire interest in PRS to DC2. PRS owns Asset G. The average of PRS's adjusted basis as of the close of each quarter of PRS's taxable year in Asset G is $100x. DC1's section 704(b) distributive share of the depreciation deduction with respect to Asset G is 25 percent with respect to PRS's entire year. DC2's section 704(b) distributive share of the depreciation deduction with respect to Asset G is also 25 percent with respect to PRS's entire year. Both DC1's and DC2's entire distributive shares of the depreciation deduction with respect to Asset G are allocated and apportioned under §1.250(b)–1(d)(2) to DC1's and DC2's gross DEI, respectively, for Year 1. PRS's allocations satisfy section 706(d).

(B) *Analysis*—(*1*) *DC1.* Because DC1 owns an interest in PRS during DC1's taxable year and receives a distributive share of partnership items of the partnership under section 706(d), DC1 has partnership QBAI with respect to PRS in the amount determined under paragraph (g)(2) of this section. Under paragraph (g)(3)(i) of this section, DC1's partner adjusted basis in Asset G is $25x, the product of $100x (the partnership's adjusted basis in the property) and 25 percent (DC1's section 704(b) distributive share of depreciation deduction with respect to Asset G). Therefore, DC1's partnership QBAI with respect to PRS is $25x. Accordingly, under paragraph (g)(1) of this section, DC1 increases its QBAI by $25x for Year 1.

(*2*) *DC2.* DC2's partner adjusted basis in Asset G is also $25x, the product of $100x (the partnership's adjusted basis in the property) and 25 percent (DC2's section 704(b) distributive share of depreciation deduction with respect to Asset G). Therefore, DC2's partnership QBAI with respect to PRS is $25x. Accordingly, under paragraph (g)(1) of this section, DC2 increases its QBAI by $25x for Year 1.

(vi) *Example 5: Partnership adjusted basis; distribution of property in liquidation of partnership interest*—(A) *Facts.* DC1, DC2, and DC3 are equal partners in PRS, a partnership. DC1 and DC2 each has an adjusted basis of $100x in its partnership interest. DC3 has an adjusted basis of $50x in its partnership interest. PRS has a section 754 election in effect. PRS owns Asset H with a fair market value of $50x and an adjusted basis of $0, Asset I with a fair market value of $100x and an adjusted basis of $100x, and Asset J with a fair market value of $150x and an adjusted basis of $150x. Asset H and Asset J are tangible property, but Asset I is not tangible property. PRS distributes Asset I to DC3 in liquidation of DC3's interest in PRS. None of DC1, DC2, DC3, or PRS recognizes gain on the distribution. Under section 732(b), DC3's adjusted basis in Asset I is $50x. PRS's adjusted basis in Asset H is increased by $50x to $50x under section 734(b)(1)(B), which is the amount by which PRS's adjusted basis in Asset I immediately before the distribution exceeds DC3's adjusted basis in Asset I.

(B) *Analysis.* Under paragraph (g)(6) of this section, PRS's adjusted basis in Asset H is determined without regard to any adjustments under section 734(b) except for adjustments under section 734(b)(1)(B) or section 734(b)(2)(B) that are attributable to distributions of tangible property and for adjustments under section 734(b)(1)(A) or 734(b)(2)(A). The adjustment to the adjusted basis in Asset H is under section 734(b)(1)(B) and is attributable to the distribution of Asset I, which is not tangible property. Accordingly, for purposes of applying paragraph (g)(1) of this section, PRS's adjusted basis in Asset H is $0.

(h) *Anti-avoidance rule for certain transfers of property*—(1) *In general.* If, with a principal purpose of decreasing the amount of its deemed tangible income return, a domestic corporation transfers specified tangible property (*transferred property*) to a specified related party of the domestic corporation and, within the disqualified period, the domestic corporation or an FDII-eligible related party of the domestic corporation leases the same or substantially similar property from any specified related party, then, solely for purposes of determining the QBAI of the domestic corporation under paragraph (b) of this section, the domestic corporation is treated as owning the transferred property from the later of the beginning of the term of the lease or date of the transfer of the property until the earlier of the end of the term of the lease or the end of the recovery period of the property.

(2) *Rule for structured arrangements.* For purposes of paragraph (h)(1) of this section, a transfer of specified tangible property to a person that is not a related party or lease of property from a person that is not a related party is treated as a transfer to or lease from a specified related party if the transfer or lease is pursuant to a structured arrangement. A structured arrangement exists only if either paragraph (h)(2)(i) or (ii) of this section is satisfied.

(i) The reduction in the domestic corporation's deemed tangible income return is priced into the terms of the arrangement with the transferee.

(ii) Based on all the facts and circumstances, the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement. Facts and circumstances that indicate the reduction in the domestic corporation's deemed tangible income return is a principal purpose of the arrangement include—

(A) Marketing the arrangement as tax-advantaged where some or all of the tax advantage derives from the reduction in the domestic corporation's deemed tangible income return;

(B) Primarily marketing the arrangement to domestic corporations which earn FDDEI;

(C) Features that alter the terms of the arrangement, including the return, in the event the reduction in the domestic corporation's deemed tangible income return is no longer relevant; or

(D) A below-market return absent the tax effects or benefits resulting from the reduction in the domestic corporation's deemed tangible income return.

(3) *Per se rules for certain transactions.* For purposes of paragraph (h)(1) of this section, a transfer of property by a domestic corporation to a specified related party (including a party deemed to be a specified related party under paragraph (h)(2) of this section) followed by a lease of the same or substantially similar property by the domestic corporation or an FDII-eligible related party from a specified related party (including a party deemed to be a specified related party under paragraph (h)(2) of this section) is treated per se as occurring pursuant to a principal purpose of decreasing the amount of the domestic corporation's deemed tangible income return if both the transfer and the lease occur within a six-month period.

(4) *Definitions related to anti-avoidance rule.* The following definitions apply for purpose of this paragraph (h).

(i) *Disqualified period.* The term *disqualified period* means, with respect to a transfer, the period beginning one year before the date of the transfer and ending the earlier of the end of the remaining recovery period (under the system described in section 951A(d)(3)(A)) of the property or one year after the date of the transfer.

(ii) *FDII-eligible related party.* The term *FDII-eligible related party* means, with respect to a domestic corporation, a member of the same consolidated group as the domestic corporation or a partnership with respect to which at least 80 percent of the interests in partnership capital and profits are owned, directly or indirectly, by the domestic corporation or one or more members of the consolidated group that includes the domestic corporation.

(iii) *Specified related party.* The term *specified related party* means, with respect to a domestic corporation, a related party other than an FDII-eligible related party.

(iv) *Transfer.* The term *transfer* means any disposition, exchange, contribution, or distribution of property, and includes an indirect transfer. For example, a transfer of an interest in a partnership is treated as a transfer of the assets of the partnership. In addition, if paragraph (h)(1) of this section applies to treat a domestic corporation as owning specified tangible property by reason of a lease of property, the termination or lapse of the lease of the property is treated as a transfer of the specified tangible property by the domestic corporation to the lessor.

(5) *Transactions occurring before March 4, 2019.* Paragraph (h)(1) of this section does not apply to a transfer of property that occurs before March 4, 2019.

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

(i) *Example 1: Sale-leaseback with a related party*—(A) *Facts.* DC, a domestic corporation, owns Asset A, which is specified tangible property. DC also owns all the single class of stock of DS, a domestic corporation, and FS1 and FS2, each a controlled foreign corporation. DC and DS are members of the same consolidated group. On January 1, Year 1, DC sells Asset A to FS1. At the time of the sale, Asset A had a remaining recovery period of 10 years under the alternative depreciation system. On February 1, Year 1, FS2 leases Asset B, which is substantially similar to Asset A, to DS for a five-year term ending on January 31, Year 6.

(B) *Analysis.* Because DC transfers specified tangible property (Asset A), to a specified related party of DC (FS1), and, within a six month period (January 1, Year 1 to February 1, Year 1), an FDII-eligible related party of DC (DS) leases a substantially similar property (Asset B) from a specified related party (FS2), DC's transfer of Asset A and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from February 1, Year 1, the later of the date of the transfer of Asset A (January 1, Year 1) and the beginning of the term of the lease of Asset B (February 1, Year 1), until January 31, Year 6, the earlier of the end of the term of the lease of Asset B (January 31, Year 6) or the remaining recovery period of Asset A (December 31, Year 10).

(ii) *Example 2: Sale-leaseback with a related party; lapse of initial lease*—(A)

Facts. The facts are the same as in paragraph (h)(6)(i)(A) of this section (the facts in *Example 1*). In addition, DS allows the lease of Asset B to expire on February 1, Year 6. On June 1, Year 6, DS and FS2 renew the lease for a five-year term ending on May 31, Year 11.

(B) *Analysis*. Because DC is treated as owning Asset A under paragraph (h)(1) of this section, the lapse of the lease of Asset B is treated as a transfer of Asset A to FS2 on February 1, Year 6, under paragraph (h)(4)(iv) of this section. Further, because DC is deemed to transfer specified tangible property (Asset A) to a specified related party (FS2) upon the lapse of the lease, and within a six month period (February 1, Year 6 to June 1, Year 6), an FDII-eligible related party of DC (DS) leases a substantially similar property (Asset B), DC's deemed transfer of Asset A under paragraph (h)(4)(iv) of this section and lease of Asset B are treated as per se occurring pursuant to a principal purpose of decreasing the amount of its deemed tangible income return. Accordingly, for purposes of determining DC's QBAI, DC is treated as owning Asset A from June 1, Year 6, the later of the date of the deemed transfer of Asset A (February 1, Year 6) and the beginning of the term of the lease of Asset B (June 1, Year 6), until December 31, Year 10, the earlier of the end of the term of the lease of Asset B (May 31, Year 11) or the remaining recovery period of Asset A (December 31, Year 10).

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§ 1.250(b)–3 Foreign-derived deduction eligible income (FDDEI) transactions.

(a) *Scope*. This section provides rules related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (b) of this section provides definitions related to the determination of whether a sale of property or provision of a service is a FDDEI transaction. Paragraph (c) of this section provides rules regarding a sale of property or provision of a service to a foreign government or an agency or instrumentality thereof. Paragraph (d) of this section provides a rule for characterizing a transaction with both sales and services elements. Paragraph (e) of this section provides a rule for determining whether a sale of property or provision of a service to a partnership is a FDDEI transaction. Paragraph (f) of this section provides rules for substantiating certain FDDEI transactions.

(b) *Definitions*. This paragraph (b) provides definitions that apply for purposes of this section and §§ 1.250(b)–4 through 1.250(b)–6.

(1) *Digital content*. The term *digital content* means a computer program or any other content in digital format. For example, digital content includes books in digital format, movies in digital format, and music in digital format. For purposes of this section, a computer program is a set of statements or instructions to be used directly or indirectly in a computer or other electronic device in order to bring about a certain result, and includes any media, user manuals, documentation, data base, or similar item if the media, user manuals, documentation, data base, or other similar item is incidental to the operation of the computer program.

(2) *End user*. Except as modified by § 1.250(b)–4(d)(2)(ii), the term *end user* means the person that ultimately uses or consumes property or a person that acquires property in a foreign retail sale. A person that acquires property for resale or otherwise as an intermediary is not an end user.

(3) *FDII filing date*. The term *FDII filing date* means, with respect to a sale of property by a seller or provision of a service by a renderer, the date, including extensions, by which the seller or renderer is required to file an income tax return (or in the case of a seller or renderer that is a partnership, a return of partnership income) for the taxable year in which the gross income from the sale of property or provision of a service is included in the gross income of the seller or renderer.

(4) *Finished goods*. The term *finished goods* means general property that is acquired by an end user.

(5) *Foreign person*. The term *foreign person* means a person (as defined in section 7701(a)(1)) that is not a United States person and includes a foreign

government or an international organization.

(6) *Foreign related party*. The term *foreign related party* means, with respect to a seller or renderer, any foreign person that is a related party of the seller or renderer.

(7) *Foreign retail sale*. The term *foreign retail sale* means a sale of general property to a recipient that acquires the general property at a physical retail location (such as a store or warehouse) outside the United States.

(8) *Foreign unrelated party*. The term *foreign unrelated party* means, with respect to a seller, a foreign person that is not a related party of the seller.

(9) *Fungible mass of general property*. The term *fungible mass of general property* means multiple units of property for sale with similar or identical characteristics for which the seller does not know the specific identity of the recipient or the end user for a particular unit.

(10) *General property*. The term *general property* means any property other than: Intangible property (as defined in paragraph (b)(11) of this section); a security (as defined in section 475(c)(2)); an interest in a partnership, trust, or estate; a commodity described in section 475(e)(2)(A) that is not a physical commodity; or a commodity described in section 475(e)(2)(B) through (D). A physical commodity described in section 475(e)(2)(A) is treated as general property, including if it is sold pursuant to a forward or option contract (including a contract described in section 475(e)(2)(C), but not a section 1256 contract as defined in section 1256(b) or other similar contract that is traded on a U.S. or non-U.S. regulated exchange and cleared by a central clearing organization in a manner similar to a section 1256 contract) that is physically settled by delivery of the commodity (provided that the taxpayer physically settled the contract pursuant to a consistent practice adopted for business purposes of determining whether to cash or physically settle such contracts under similar circumstances).

(11) *Intangible property*. The term *intangible property* has the meaning set forth in section 367(d)(4). For purposes of section 250, intangible property does not include a copyrighted article as defined in §1.861–18(c)(3).

(12) *International transportation property*. The term *international transportation property* means aircraft, railroad rolling stock, vessel, motor vehicle, or similar property that provides a mode of transportation and is capable of traveling internationally.

(13) *IP address*. The term *IP address* means a device's internet Protocol address.

(14) *Recipient*. The term *recipient* means a person that purchases property or services from a seller or renderer.

(15) *Renderer*. The term *renderer* means a person that provides a service to a recipient.

(16) *Sale*. The term *sale* means any sale, lease, license, sublicense, exchange, or other disposition of property, and includes any transfer of property in which gain or income is recognized under section 367. In addition, the term *sell* (and any form of the word sell) means any transfer by sale.

(17) *Seller*. The term *seller* means a person that sells property to a recipient.

(18) *United States*. The term *United States* has the meaning set forth in section 7701(a)(9), as expanded by section 638(1) with respect to mines, oil and gas wells, and other natural deposits.

(19) *United States person*. The term *United States person* has the meaning set forth in section 7701(a)(30), except that the term does not include an individual that is a bona fide resident of a United States territory within the meaning of section 937(a).

(20) *United States territory*. The term *United States territory* means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands.

(c) *Foreign military sales and services*. If a sale of property or a provision of a service is made to the United States or an instrumentality thereof pursuant to 22 U.S.C. 2751 *et seq*. under which the United States or an instrumentality thereof purchases the property or service for resale or on-service to a foreign government or agency or instrumentality thereof, then the sale of property or provision of a service is treated as a

FDDEI sale or FDDEI service without regard to §1.250(b)–4 or §1.250(b)–5.

(d) *Transactions with multiple elements*. A transaction is classified according to its overall predominant character for purposes of determining whether the transaction is a FDDEI sale under §1.250(b)–4 or a FDDEI service under §1.250(b)–5. For example, whether a transaction that includes both a sales component and a service component is subject to §1.250(b)–4 or §1.250(b)–5 is determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale or service. In addition, whether a transaction that includes both a sale of general property and a sale of intangible property is subject to §1.250(b)–4(d)(1) or §1.250(b)–4(d)(2) is determined based on whether the overall predominant character, taking into account all relevant facts and circumstances, is a sale of general property or a sale of intangible property.

(e) *Treatment of partnerships*—(1) *In general*. For purposes of determining whether a sale of property to or by a partnership or a provision of a service to or by a partnership is a FDDEI transaction, a partnership is treated as a person. Accordingly, for example, a partnership may be a seller, renderer, recipient, or related party, including a foreign related party (as defined in paragraph (b)(6) of this section).

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

(i) *Example 1: Domestic partner sale to foreign partnership with a foreign branch*—(A) *Facts*. DC, a domestic corporation, is a partner in PRS, a foreign partnership. DC and PRS are not related parties. PRS has a foreign branch within the meaning of §1.904–4(f)(3)(iii). DC and PRS both use the calendar year as their taxable year. For the taxable year, DC recognizes $20x of gain on the sale of general property to PRS for a foreign use (as determined under §1.250(b)–4(d)). During the same taxable year, PRS recognizes $20x of gain on the sale of other general property to a foreign person for a foreign use (as determined under §1.250(b)–4(d)). PRS's income on the sale of the property is attributable to its foreign branch.

(B) *Analysis*. DC's sale of property to PRS, a foreign partnership, is a FDDEI sale because it is a sale to a foreign person for a foreign use. Therefore, DC's gain of $20x on the sale to PRS is included in DC's gross DEI and gross FDDEI. However, PRS's gain of $20x is not included in the gross DEI or gross FDDEI of PRS because the gain is foreign branch income within the meaning of §1.250(b)–1(c)(11). Accordingly, none of PRS's gain on the sale of property is included in DC's gross DEI or gross FDDEI under §1.250(b)–1(e)(1).

(ii) *Example 2: Domestic partner sale to domestic partnership without a foreign branch*—(A) *Facts*. The facts are the same as in paragraph (e)(2)(i)(A) of this section (the facts in *Example 1*), except PRS is a domestic partnership that does not have a foreign branch within the meaning of §1.904–4(f)(3)(iii).

(B) *Analysis*. DC's sale of property to PRS, a domestic partnership, is not a FDDEI sale because the sale is to a United States person. Therefore, the gross income from DC's sale to PRS is included in DC's gross DEI but is not included in its gross FDDEI. However, PRS's sale of other general property is a FDDEI sale, and therefore the gain of $20x is included in the gross DEI and gross FDDEI of PRS. Accordingly, DC includes its distributive share of PRS's gain from the sale in determining DC's gross DEI and gross FDDEI for the taxable year under §1.250(b)–1(e)(1).

(f) *Substantiation for certain FDDEI transactions*—(1) *In general*. Except as provided in paragraph (f)(2) of this section, for purposes of §1.250(b)–4(d)(1)(ii)(C) (foreign use for sale of general property for resale), §1.250(b)–4(d)(1)(iii) (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), §1.250(b)–4(d)(2) (foreign use for sale of intangible property), and §1.250(b)–5(e) (general services provided to business recipients located outside the United States), a transaction is a FDDEI transaction only if the taxpayer substantiates its determination of foreign use (in the case of sales of property) or location outside the United States (in the case of general services provided to a business recipient) as described in the applicable paragraph of §1.250(b)–4(d)(3) or §1.250(b)–5(e)(4). The substantiating documents must be in existence as of the FDII filing date with respect to the FDDEI transaction, and a taxpayer must provide the required substantiating documents within 30 days of a request by the Commissioner or another period as agreed between the Commissioner and the taxpayer.

(2) *Exception for small businesses.* Paragraph (f)(1) of this section, and the specific substantiation requirements described in the applicable paragraph of §1.250(b)–4(d)(3) or §1.250(b)–5(e)(4), do not apply to a taxpayer if the taxpayer and all related parties of the taxpayer, in the aggregate, receive less than $25,000,000 in gross receipts during the taxable year prior to the FDDEI transaction. If the taxpayer's prior taxable year was less than 12 months (a short period), gross receipts are annualized by multiplying the gross receipts for the short period by 365 and dividing the result by the number of days in the short period.

(3) *Treatment of certain loss transactions*—(i) *In general.* If a domestic corporation fails to satisfy the substantiation requirements described in the applicable paragraph of §1.250(b)–4(d)(3) or §1.250(b)–5(e)(4) with respect to a transaction (including in connection with a related party transaction described in §1.250(b)–6), the gross income from the transaction will be treated as gross FDDEI if—

(A) In the case of a sale of property, the seller knows or has reason to know that property is sold to a foreign person for a foreign use (within the meaning of §1.250(b)–4(d)(1) or (2));

(B) In the case of the provision of a general service to a business recipient, the renderer knows or has reason to know that a service is provided to a business recipient located outside the United States; and

(C) Not treating the transaction as a FDDEI transaction would increase the amount of the corporation's FDDEI for the taxable year relative to its FDDEI that would be determined if the transaction were treated as a FDDEI transaction.

(ii) *Reason to know*—(A) *Sales to a foreign person for a foreign use.* For purposes of paragraph (f)(3)(i)(A) of this section, a seller has reason to know that a sale is to a foreign person for a foreign use if the information received as part of the sales process contains information that indicates that the recipient is a foreign person or that the sale is for a foreign use, and the seller fails to obtain evidence establishing that the recipient is not in fact a foreign person or that the sale is not in fact for a foreign use. Information that indicates that a recipient is a foreign person or that the sale is for a foreign use includes, but is not limited to, a foreign phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed outside the United States.

(B) *General services provided to a business recipient located outside the United States.* For purposes of paragraph (f)(3)(i)(B) of this section, a renderer has reason to know that the provision of a general service is to a business recipient located outside the United States if the information received as part of the sales process contains information that indicates that the recipient is a business recipient located outside the United States and the seller fails to obtain evidence establishing that the recipient is not in fact a business recipient located outside the United States. Information that indicates that a recipient is a business recipient includes, but is not limited to, indicia of a business status (such as ''LLC'' or ''Company,'' or similar indicia under applicable domestic or foreign law, in the name) or statements by the recipient indicating that it is a business. Information that indicates that a business recipient is located outside the United States includes, but is not limited to, a foreign phone number, billing address, and evidence that the entity or business is incorporated, formed, or managed outside the United States.

(iii) *Multiple transactions.* If a seller or renderer engages in more than one transaction described in paragraph (f)(3)(i) of this section in a taxable year, paragraph (f)(3)(i) of this section applies by comparing the corporation's FDDEI if each such transaction were not treated as a FDDEI transaction to its FDDEI if each such transaction were treated as a FDDEI transaction.

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

(A) *Facts*. During a taxable year, DC, a domestic corporation, manufactures products A and B in the United States. DC sells product A and product B to Y, a foreign person that is a distributor, for $200x and $800x, respectively. DC knows or has reason to know that all of its sales of product A and product B will ultimately be sold to end users located outside the United States. Y provides DC with a statement that satisfies the substantiation requirement of paragraph (f)(1) of this section and §1.250(b)–4(d)(3)(ii) that establishes that its sales of product B are for a foreign use but does not obtain substantiation establishing that any sales of product A are for a foreign use. DC's cost of goods sold is $450x. For purposes of determining gross FDDEI, under §1.250(b)–1(d)(1) DC attributes $250x of cost of goods sold to product A and $200x of cost of goods sold to product B, and then attributes the cost of goods sold for each product ratably between the gross receipts of such product sold to foreign persons and the gross receipts of such product not sold to foreign persons. The manner in which DC attributes the cost of goods sold is a reasonable method. DC has no other items of income, loss, or deduction.

TABLE 1 TO PARAGRAPH (F)(3)(IV)(A)

	Product A	Product B	Total
Gross receipts	$200x	$800x	$1,000x
Cost of Goods Sold	250x	200x	450x
Gross Income (Loss)	(50x)	600x	550x

(B) *Analysis*. By not treating the sales of product A as FDDEI sales, the amount of DC's FDDEI would increase by $50x relative to its FDDEI if the sales of product A were treated as FDDEI sales. Accordingly, because DC knows or has reason to know that its sales of product A are to foreign persons for a foreign use, the sales of product A constitute FDDEI sales under paragraph (f)(3) of this section, and thus the $50x loss from the sale of product A is included in DC's gross FDDEI.

[T.D. 9901, 85 FR 43080, July 15, 2020]

§ 1.250(b)–4 Foreign-derived deduction eligible income (FDDEI) sales.

(a) *Scope*. This section provides rules for determining whether a sale of property is a FDDEI sale. Paragraph (b) of this section defines a FDDEI sale. Paragraph (c) of this section provides rules for determining whether a recipient is a foreign person. Paragraph (d) of this section provides rules for determining whether property is sold for a foreign use. Paragraph (e) of this section provides a special rule for the sale of interests in a disregarded entity. Paragraph (f) of this section provides a rule regarding certain hedging transactions with respect to FDDEI sales.

(b) *Definition of FDDEI sale*. Except as provided in §1.250(b)–6(c), the term *FDDEI sale* means a sale of general property or intangible property to a recipient that is a foreign person (see paragraph (c) of this section for presumption rules relating to determining foreign person status) and that is for a foreign use (as determined under paragraph (d) of this section). A sale of any property other than general property or intangible property is not a FDDEI sale.

(c) *Presumption of foreign person status*—(1) *In general*. The sale of property is presumed to be to a recipient that is a foreign person for purposes of paragraph (b) of this section if the sale is described in paragraph (c)(2) of this section. However, this presumption does not apply if the seller knows or has reason to know that the sale is not to a foreign person. A seller has reason to know that a sale is not to a foreign person if the information received as part of the sales process contains information that indicates that the recipient is not a foreign person and the seller fails to obtain evidence establishing that the recipient is in fact a foreign person. Information that indicates that a recipient is not a foreign person include, but are not limited to, a United States phone number, billing address, shipping address, or place of residence; and, with respect to an entity, evidence that the entity is incorporated, formed, or managed in the United States.

(2) *Sales of property.* A sale of a property is described in this paragraph (c)(2) if:

(i) The sale is a foreign retail sale;

(ii) In the case of a sale of general property that is not a foreign retail sale and the general property is delivered (such as through a commercial carrier) to the recipient or an end user, the shipping address of the recipient or end user is outside the United States;

(iii) In the case of a sale of general property that is not described in either paragraph (c)(2)(i) or (ii) of this section, the billing address of the recipient is outside the United States; or

(iv) In the case of a sale of intangible property, the billing address of the recipient is outside the United States.

(d) *Foreign use*—(1) *Foreign use for general property*—(i) *In general.* The sale of general property is for a foreign use for purposes of paragraph (b) of this section if the seller determines that the sale is for a foreign use under the rules of paragraph (d)(1)(ii) or (iii) of this section and the exception in paragraph (d)(1)(iv) of this section does not apply.

(ii) *Rules for determining foreign use*—(A) *Sales that are delivered to an end user by a carrier or freight forwarder.* Except as otherwise provided in this paragraph (d)(1)(ii)(A), a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) that is delivered through a carrier or freight forwarder to a recipient that is an end user is for a foreign use if the end user receives delivery of the general property outside the United States. However, a sale described in the preceding sentence is not treated as a sale to an end user for a foreign use if the sale is made with a principal purpose of having the property transported from its location outside the United States to a location within the United States for ultimate use or consumption.

(B) *Sales to an end user without the use of a carrier or freight forwarder.* With respect to sales that are not delivered through the use of a carrier or freight forwarder, a sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) to a recipient that is an end user is for a foreign use if the property is located outside the United States at the time of the sale (including as part of foreign retail sales).

(C) *Sales for resale.* A sale of general property (other than a sale of general property described in paragraphs (d)(1)(ii)(D) through (F) of this section) to a recipient (such as a distributor or retailer) that will resell the general property is for a foreign use if the general property will ultimately be sold to end users outside the United States (including in foreign retail sales) and such sales to end users outside the United States are substantiated under paragraph (d)(3)(ii) of this section. In the case of sales of a fungible mass of general property, the taxpayer may presume that the proportion of its sales that are ultimately sold to end users outside the United States is the same as the proportion of the recipient's resales of that fungible mass to end users outside the United States.

(D) *Sales of digital content.* A sale of general property that primarily contains digital content that is transferred electronically rather than in a physical medium is for a foreign use if the end user downloads, installs, receives, or accesses the purchased digital content on the end user's device outside the United States (see §1.250(b)–5(d)(2) and (e)(2)(iii) for rules that apply in the case of digital content that is not purchased in a sale but is electronically supplied as a service). If information about where the digital content is downloaded, installed, received, or accessed (such as the device's IP address) is unavailable, and the gross receipts from all sales with respect to the end user (which may be a business) are in the aggregate less than $50,000 for the seller's taxable year, a sale of general property described in the preceding sentence is for a foreign use if it is to an end user that has a billing address located outside the United States.

(E) *Sales of international transportation property used for compensation or hire.* A sale of international transportation property used for compensation or hire is for a foreign use if the end user registers the property with a foreign jurisdiction.

(F) *Sales of international transportation property not used for compensation or hire.* A sale of international transportation property not used for compensation or hire is for a foreign use if the end user registers the property in a foreign jurisdiction and hangars or stores the property primarily outside the United States.

(iii) *Sales for manufacturing, assembly, or other processing*—(A) *In general.* A sale of general property is for a foreign use if the sale is to a foreign unrelated party that subjects the property to manufacture, assembly, or other processing outside the United States and such manufacturing, assembly, or other processing outside the United States is substantiated under paragraph (d)(3)(iii) of this section. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (as described in paragraph (d)(1)(iii)(B) of this section) or the property is incorporated as a component into another product (as described in paragraph (d)(1)(iii)(C) of this section).

(B) *Property subject to a physical and material change.* The determination of whether general property is subject to a physical and material change is made based on all the relevant facts and circumstances. General property is subject to a physical and material change if it is substantially transformed and is distinguishable from and cannot be readily returned to its original state.

(C) *Property incorporated into a product as a component.* General property is a component incorporated into another product if the incorporation of the general property into another product involves activities that are substantial in nature and generally considered to constitute the manufacture, assembly, or processing of property based on all the relevant facts and circumstances. However, general property is not considered a component incorporated into another product if it is subject only to packaging, repackaging, labeling, or minor assembly operations. In addition, general property is treated as a component if the seller expects, using reliable estimates, that the fair market value of the property when it is delivered to the recipient will constitute no more than 20 percent of the fair market value of the finished good into which the general property is directly or indirectly incorporated when the finished good is sold to end users (the "20-percent rule"). If the property could be incorporated into a number of different finished goods, a reliable estimate of the fair market value of the finished good may include the average fair market value of a representative range of such goods. For purposes of the 20-percent rule, all general property that is sold by the seller and incorporated into the finished good is treated as a single item of property if the seller sells the property to the recipient and the seller knows or has reason to know that the components will be incorporated into a single item of property (for example, where multiple components are sold as a kit). A seller knows or has reason to know that the components will be incorporated into a single item of property if the information received as part of the sales process indicates that the components will be included in the same second product or the nature of the components compels inclusion into the second product and the seller fails to obtain evidence to the contrary.

(iv) *Sales of property subject to manufacturing, assembly, or other processing in the United States.* If the seller sells general property to a recipient (other than a related party) for manufacturing, assembly, or other processing within the United States, such property is not sold for a foreign use even if the requirements of paragraph (d)(1)(ii) or (iii) of this section are subsequently satisfied. See §1.250(b)–6(c) for rules governing sales of general property to a foreign person that is a related party. Property is subject to manufacture, assembly, or other processing only if the property is physically and materially changed (as described in paragraph (d)(1)(iii)(B) of this section) or the property is incorporated as a component into another product (as described in paragraph (d)(1)(iii)(C) of this section).

(v) *Examples.* The following examples illustrate the application of this paragraph (d)(1).

(A) *Assumed facts.* The following facts are assumed for purposes of the examples—

(*1*) DC is a domestic corporation.

(*2*) FP is a foreign person that is a foreign unrelated party with respect to DC.

(*3*) To the extent a sale is for a foreign use, any applicable substantiation requirements described in paragraph (d)(3)(ii) or (iii) of this section are satisfied.

(B) *Examples—*

(*1*) *Example 1: Manufacturing outside the United States—*(*i*) *Facts.* DC sells batteries for $18x to FP. DC expects that FP will insert the batteries into tablets as part of the process of assembling tablets outside the United States. While the tablets are manufactured in a way that end users would not easily be able to remove the batteries, the batteries could be removed from the tablets and would resemble their original state following the removal. The finished tablets will be sold to end users within and outside the United States. DC's batteries are used in two types of tablets, Tablet A and Tablet B. Based on an economic analysis, DC determines that the fair market value of Tablet A is $90x and the fair market value of Tablet B is $110x. FP informs DC that the number of sales of Tablet A is approximately equal to the number of sales of Tablet B.

(*ii*) *Analysis.* Because the batteries could be removed from the tablets and be returned to their original state, the insertion of the batteries into the tablets does not constitute a physical and material change described in paragraph (d)(1)(iii)(B) of this section. However, the average fair market value of a representative range of tablets that incorporate the batteries is $100x (the average of $90x for Tablet A and $110x for Tablet B because their sales are approximately equal), and $18x is less than 20 percent of $100x. Therefore, the batteries are considered components of the tablets and treated as subject to manufacture, assembly, or other processing outside the United States. See paragraphs (d)(1)(iii)(A) and (C) of this section. As a result, notwithstanding that some tablets incorporating the batteries may be sold to an end user in the United States, DC's sale of batteries is considered for a foreign use. Accordingly, DC's sale of batteries to FP is for a foreign use under paragraph (d)(1)(iii)(A) and (C) of this section, and the sale is a FDDEI sale.

(*2*) *Example 2: Manufacturing outside the United States—*(*i*) *Facts.* The facts are the same as in paragraph (d)(1)(v)(B)(*1*) of this section (the facts in *Example 1*), except FP purchases the batteries from DC for $25x. In addition, FP purchased other components of tablets from other parties. FP has a substantial investment in machinery and tools that are used to assemble tablets.

(*ii*) *Analysis.* Even though the fair market value of the batteries that FP purchases from DC and incorporates into the tablets exceeds 20 percent of the fair market value of the tablets, because the batteries are used by FP in activities that are substantial in nature and generally considered to constitute the manufacture, assembly or other processing of property, the batteries are components of the tablets. As a result, DC's sale of property to FP is still for a foreign use under paragraph (d)(1)(iii)(A) and (C) of this section, and the sale is a FDDEI sale.

(*3*) *Example 3: Sale of products to distributor outside the United States—*(*i*) *Facts.* DC sells smartphones to FP, a distributor of electronics located within Country A. The sales contract between DC and FP provides that FP may sell the smartphones it purchases from DC only to specified retailers located within Country A. The specified retailers only sell electronics, including smartphones, in foreign retail sales.

(*ii*) *Analysis.* Although FP does not sell the smartphones it purchases from DC to end users, FP sells to retailers that sell the smartphones in foreign retail sales. All of the sales of smartphones from DC to FP are sales of general property for a foreign use under paragraph (d)(1)(ii)(C) of this section because FP is only allowed to sell the smartphones to retailers who sell such property in foreign retail sales. As a result, DC's sales of smartphones to FP are FDDEI sales.

(*4*) *Example 4: Sale of a fungible mass of products*—(*i*) *Facts*. DC and persons other than DC sell multiple units of printer paper that is considered fungible general property to FP during the taxable year. FP is a distributor that sells paper to retail stores within and outside the United States. FP informs DC that approximately 25 percent of FP's sales of the paper are to retail stores located outside of the United States for foreign retail sales.

(*ii*) *Analysis*. The sale of paper to FP is for a foreign use to the extent that the paper will be sold to end users located outside the United States under paragraph (d)(1)(ii)(C) of this section. Because a portion of DC's sales to FP are not for a foreign use, DC must determine the amount of paper that is sold for a foreign use. Based on the information provided by FP about its own sales, DC determines under paragraph (d)(1)(ii)(C) of this section that 25 percent of the total units of paper that is fungible general property that FP purchased from all persons in the taxable year will ultimately be sold to end users located outside the United States. Accordingly, DC satisfies the test for a foreign use under paragraph (d)(1)(ii)(C) of this section with respect to 25 percent of its sales of the paper to FP.

(*5*) *Example 5: Limited use license of copyrighted computer software*—(*i*) *Facts*. DC provides FP with a limited use license to copyrighted computer software in exchange for an annual fee of $100x. The limited use license restricts FP's use of the computer software to 100 of FP's employees, who download the software onto their computers. The limited use license prohibits FP from using the computer software in any way other than as an end user, which includes prohibiting sublicensing, selling, reverse engineering, or modifying the computer software. All of FP's employees download the software onto computers that are physically located outside the United States.

(*ii*) *Analysis*. The software licensed to FP is digital content as defined in §1.250(b)–3(b)(1), and is downloaded by an end user as defined in §1.250(b)–3(b)(2). Accordingly, because the software is downloaded solely onto computers outside the United States, DC's license to FP is for a foreign use and therefore a FDDEI sale under paragraph (d)(1)(ii)(D) of this section. The entire $100x of the license fee is included in DC's gross FDDEI for the taxable year.

(*6*) *Example 6: Limited use license of copyrighted computer software used within and outside the United States*—(*i*) *Facts*. The facts are the same as in paragraph (d)(1)(v)(B)(*5*) of this section (the facts in *Example 5*), except that FP has offices both within and outside the United States, and DC's internal records indicates that 50 percent of the downloads of the software are onto computers located outside the United States.

(*ii*) *Analysis*. Because 50 percent of the downloads of the software are onto computers located outside the United States, a portion of DC's license to FP is for a foreign use and therefore such portion is a FDDEI sale. The $50x of license fee derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(*7*) *Example 7: Sale of a copyrighted article*—(*i*) *Facts*. DC sells copyrighted music available for download on its website. Once downloaded, the recipient listens to the music on electronic devices that do not need to be connected to the internet. DC has data that an individual accesses the website to purchase a song for download on a device located outside the United States. The terms of the sale permit the recipient to use the song for personal use, but convey no other rights to the copyrighted music to the recipient.

(*ii*) *Analysis*. The music acquired through download is digital content as defined in §1.250(b)–3(b)(1). Because the recipient acquires no ownership in copyright rights to the music, the sale is considered a sale of a copyrighted article, and thus is a sale of general property. See §1.250(b)–3(b)(10) and (11). As a result, the sale is considered for a foreign use under paragraph (d)(1)(ii)(D) of this section because the digital content was installed, received, or accessed on the end user's device outside the United States. The income derived with respect to the sale of the music is included in DC's gross FDDEI for the taxable year. See §1.250(b)–5(d)(3) for an example of digital content provided to consumers as a service rather than as a sale.

(2) *Foreign use for intangible property*—(i) *In general*. A sale of rights to exploit intangible property solely outside the United States is for a foreign use. A sale of rights to exploit intangible property solely within the United States is not for a foreign use. A sale of rights to exploit intangible property worldwide is partially for a foreign use and partially not for a foreign use. Whether intangible property is exploited within versus outside the United States is determined based on revenue earned from end users located within versus outside the United States. Therefore, a sale of rights to exploit intangible property both within and outside the United States is for a foreign use in proportion to the revenue earned from end users located outside the United States over the total revenue earned from the exploitation of the intangible property. A sale of intangible property will be treated as a FDDEI sale only if the substantiation requirements of paragraph (d)(3)(iv) of this section are satisfied. For rules specific to determining end users and revenue earned from end users for intangible property used in sales of general property, provision of services, research and development, or consisting of a manufacturing method or process, see paragraph (d)(2)(ii) of this section.

(ii) *Determination of end users and revenue earned from end users*—(A) *Intangible property embedded in general property or used in connection with the sale of general property*. If intangible property is embedded in general property that is sold, or used in connection with a sale of general property, then the end user of the intangible property is the end user of the general property. Revenue is earned from the end user of the general property outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1)(ii) or (iii) of this section.

(B) *Intangible property used in providing a service*. If intangible property is used to provide a service, then the end user of that intangible property is the recipient, consumer, or business recipient of the service or, in the case of a property service or a transportation service that involves the transportation of property, the end user is the owner of the property on which such service is being performed. Such end users are treated as located outside the United States only to the extent the service qualifies as a FDDEI service under § 1.250(b)–5. Therefore, in the case of a recipient of a sale of intangible property that uses such intangible property to provide a property service that qualifies as a FDDEI service to another person, that person is the end user and is treated as located outside the United States.

(C) *Intangible property consisting of a manufacturing method or process*—(*1*) *In general*. Except as provided in paragraph (d)(2)(ii)(C)(*2*) of this section, if intangible property consists of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(*3*) of this section) and is sold to a foreign unrelated party (including in a sale by a foreign related party), then the foreign unrelated party is treated as an end user located outside the United States, unless the seller knows or has reason to know that the manufacturing method or process will be used in the United States, in which case the foreign unrelated party is treated as an end user located within the United States. A seller has reason to know that the manufacturing method or process will be used in the United States if the information received from the recipient as part of the sales process contains information that indicates that the recipient intends to use the manufacturing method or process in the United States and the seller fails to obtain evidence establishing that the recipient does not intend to use the manufacturing method or process in the United States.

(*2*) *Exception for certain manufacturing arrangements*. A sale of intangible property consisting of a manufacturing method or process (including a sale by a foreign related party) to a foreign unrelated party for use in manufacturing products for or on behalf of the seller or any person related to the seller does not qualify as a sale to a foreign unrelated party for purposes of determining the end user under paragraph (d)(2)(ii)(C)(*1*) of this section.

(*3*) *Manufacturing method or process.* For purposes of this section, a manufacturing method or process consists of a sequence of actions or steps that comprise an overall method or process that is used to manufacture a product or produce a particular manufacturing result, which may be in the form of a patent or know-how. Intangible property consisting of the right to make and sell an item of property is not a manufacturing method or process, whereas intangible property consisting of the right to apply a series of actions or steps to be performed to achieve a particular manufacturing result is a manufacturing method or process. For example, a utility or design patent on an article of manufacture, machine, composition of matter, design, or providing the right to sell equipment to perform a process is not a manufacturing method or process, whereas a utility patent covering a method or process of manufacturing is a manufacturing method or process for purposes of this section.

(D) *Intangible property used in research and development.* If intangible property (primary IP) is used to develop new or modify other intangible property (secondary IP), then the end user of the primary IP is the end user (applying paragraph (d)(2)(ii)(A), (B), or (C) of this section) of the secondary IP.

(iii) *Determination of revenue for periodic payments versus lump sums*—(A) *Sales in exchange for periodic payments.* In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, to a recipient in exchange for periodic payments, the extent to which the sale is for a foreign use is determined annually based on the actual revenue earned by the recipient from any use of the intangible property for the taxable year in which a periodic payment is received. If actual revenue earned by the recipient cannot be obtained after reasonable efforts, then estimated revenue earned by a recipient that is not a related party of the seller from the use of the intangible property may be used based on the principles of paragraph (d)(2)(iii)(B) of this section.

(B) *Sales in exchange for a lump sum.* In the case of a sale of intangible property, other than intangible property consisting of a manufacturing method or process that is sold to a foreign unrelated party, for a lump sum, the extent to which the sale is for a foreign use is determined based on the ratio of the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property outside the United States to the total net present value of revenue the seller would have expected to earn from the exploitation of the intangible property. In the case of a recipient that is a foreign unrelated party, net present values of revenue that the recipient expected to earn from the exploitation of the intangible property within and outside the United States may also be used if the seller obtained such revenue data from the recipient near the time of the sale and such revenue data was used to negotiate the lump sum price paid for the intangible property. Net present values must be determined using reliable inputs including, but not limited to, reliable revenue, expenses, and discount rates. The extent to which the inputs are used by the parties to determine the sales price agreed to between the seller and a foreign unrelated party purchasing the intangible property will be a factor in determining whether such inputs are reliable. If the intangible property is sold to a foreign related party, the reliability of the inputs used to determine net present values and the net present values are determined under section 482.

(C) *Sales to a foreign unrelated party of intangible property consisting of a manufacturing method or process.* In the case of a sale to an unrelated foreign party of intangible property consisting of a manufacturing method or process, the revenue earned from the end user is equal to the amount received from the recipient in exchange for the manufacturing method or process. In the case of a bundled sale of intangible property consisting of a manufacturing method or process and intangible property not consisting of a manufacturing method or process, the revenue earned from the intangible property consisting of the manufacturing method or process equals the total amount paid for the bundled sale multiplied by the proportion that the value of the manufacturing method or process bears to the total value of the intangible property. The value of the manufacturing method or process to the total value of the intangible property must be determined using the principles of section 482.

(iv) *Examples.* The following examples illustrate the application of this paragraph (d)(2).

(A) *Assumed facts.* The following facts are assumed for purposes of the examples—

(*1*) DC is a domestic corporation.

(*2*) Except as otherwise provided, FP and FP2 are foreign persons that are foreign unrelated parties with respect to DC.

(*3*) All of DC's income is DEI.

(*4*) Except as otherwise provided, the substantiation requirements described in paragraph (d)(3)(iv) of this section are satisfied.

(*5*) Except as otherwise provided, inputs used to determine the net present values of the revenue are reliable.

(B) *Examples*—

(*1*) *Example 1: License of worldwide rights with actual revenue data from recipient*—(*i*) *Facts.* DC licenses to FP worldwide rights to the copyright to composition A in exchange for annual royalties of 60 percent of revenue from FP's sales of composition A. FP sells composition A to customers through digital downloads from servers. In the taxable year, FP earns $100x in revenue from sales of copies of composition A to customers, of which $60x is from customers located in the United States and the remaining $40x is from customers located outside the United States. FP provides DC with reliable records showing the amount of revenue earned in the taxable year from sales of composition A to establish the royalties owed to DC. These records also provide DC with the amount of revenue earned from sales of composition A to customers located within the United States.

(*ii*) *Analysis.* FP is not the end user of the copyright to composition A under paragraph (d)(2)(ii)(A) of this section because the copyright is used in the sale of general property (the sale of copyrighted articles to customers). The customers that purchase a copy of composition A from FP are the end users (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the recipients of composition A when sold as general property. Based on the actual revenue earned by FP from sales of composition A, 40 percent ($40x/$100x) of the revenue generated by the copyright during the taxable year is earned outside the United States. Accordingly, a portion of DC's license to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. The $24x of royalty (0.40 x $60x of total royalties owed to DC during the taxable year) derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(*2*) *Example 2: Fixed annual payments for worldwide rights without actual revenue data from recipient*—(*i*) *Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(*1*)(*i*) of this section (the facts in *Example 1*), except FP pays DC a fixed annual payment of $60x each year for the worldwide rights to the copyright to composition A and does not provide DC with data showing how much revenue FP earned from sales of composition A, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from sales of composition A to customers within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC's economic analysis of the revenue DC expected it could earn annually from use of composition A as part of determining the annual payments DC would receive from FP from the license of composition A supports a determination that 40 percent of sales of composition A during the tax year would be to customers located outside the United States. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of composition A used in determining the amount of annual payments agreed to by DC and FP.

(*ii*) *Analysis.* For the same reasons provided in paragraph (d)(2)(iv)(B)(*1*)(*ii*) of this section (the analysis in *Example 1*), the customers that purchase copies of composition A from FP are the end users. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from the use of the copyright to composition A under paragraph (d)(2)(iii)(A) of this section because DC was unable to obtain actual revenue earned by FP from use of the copyright to composition A during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC's economic analysis, a portion of DC's license to FP is for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. $24x of the $60x fixed payment to DC (0.40 x $60x) is included in DC's gross FDDEI for the taxable year.

(*3*) *Example 3: Sale of patent rights protected in the United States and other countries; use of financial projections in sale to foreign unrelated party*—(*i*) *Facts.* DC owns a patent for an active pharmaceutical ingredient (''API'') approved for treatment of disease A (''indication A'') in the United States and in Countries A, B, and C. The patent is registered in the United States and in Countries A, B, and C. DC sells to FP all of its patent rights to the API for indication A for a lump sum payment of $1,000x. DC has no basis in the patent rights. To determine the sales price for the patent rights, DC projected that the net present value of the revenue it would earn from selling a pharmaceutical product incorporating the API for indication A was $5,000x, with 15 percent of the net present value of revenue earned from sales within the United States and 85 percent of the net present value of revenue earned from sales outside the United States. DC did not obtain revenue projections from the recipient.

(*ii*) *Analysis.* FP is not the end user of the patent under paragraph (d)(2)(ii)(A) of this section because the patent is used in the sale of general property (the sale of pharmaceutical products to customers) and FP is not the recipient of that general property. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the unrelated party recipients of the pharmaceutical product when sold as general property. Based on the financial projections DC used to determine the sales price of the patent that FP purchased, a portion of DC's sale to FP is for a foreign use under paragraph (d)(2) of this section and such portion is a FDDEI sale. The $850x (85 percent × $1,000x) of gain derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(*4*) *Example 4: Sale of patent rights protected in the United States and other countries; use of financial projections in sale to foreign related party*—(*i*) *Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(*3*)(*i*) of this section (the facts in *Example 3*), except that FP is a foreign related party with respect to DC, and DC projected that the net present value of the revenue it would earn from selling a pharmaceutical product incorporating the API for indication A would result in 1 percent of the revenue earned from sales within the United States and 99 percent of the revenue earned from sales outside the United States. During the examination of DC's return for the taxable year, the IRS determines that DC's substantiation allocating the projected revenue from sales within the United States and outside the United States does not reflect reliable inputs to determine the net present values of revenues under section 482, but determines that the total lump sum price FP paid for DC's patent rights is an arm's length price. The IRS determines that the most reliable net present values of revenue DC would have earned from sales within the United States and outside the United States is $750x and $4250x, respectively.

(*ii*) *Analysis.* For the same reasons provided in paragraph (d)(2)(iv)(B)(*3*)(*ii*) of this section (the analysis in *Example 3*), the customers that purchase the finished pharmaceutical product from FP are the end users. Under paragraph (d)(2)(iii)(B) of this section, the reliability of the inputs DC used to determine the net present values and the net present values are determined under section 482. Based on the sales price of the patent that FP purchased and the IRS-determined net present values of revenue DC would have earned from sales within the United States and outside the United States, a portion of DC's sale to FP is for a foreign use under paragraph (d)(2) of this section and such portion is a FDDEI sale. DC is allowed to include $850x (($4250x divided by $5000x) × $1,000x) of gain in DC's gross FDDEI for the taxable year.

(*5*) *Example 5: Sale of patent of manufacturing method or process protected in the United States and other countries; foreign unrelated party*—(*i*) *Facts*. DC owns the worldwide rights to a patent covering a process for refining crude oil. DC sells to FP the right to DC's patented process for refining crude oil for a lump sum payment of $100x. DC has no basis in the patent rights. DC does not know or have reason to know that FP will use the patented process to refine crude oil within the United States or will sell or license the rights to the patent to a person to refine crude oil within the United States.

(*ii*) *Analysis*. DC's patent covering a process for refining crude oil is a manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(*3*) of this section. Under paragraph (d)(2)(ii)(C)(*1*) of this section, FP is treated as the end user of the patent, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that the patented process will be used in the United States. As a result, all of the sale to FP is for a foreign use under paragraph (d)(2) of this section and therefore is a FDDEI sale. The entire $100x lump sum payment is included in DC's gross FDDEI for the taxable year.

(*6*) *Example 6: License of intangible property that includes a patented manufacturing method or process protected in the United States and other countries; foreign unrelated party*—(*i*) *Facts*. DC owns worldwide rights to patents, know-how, and a trademark and tradename for product Z. The patents consist of: a patent covering the right to make, use, and sell product Z (article of manufacture), a patent covering the rights to make, use, and sell a composition of substances used in certain components of product Z (composition of matter), and a patent covering the right to use a manufacturing process consisting of a series of manufacturing steps to manufacture product Z (manufacturing method or process as defined in paragraph (d)(2)(ii)(C)(*3*) of this section) and to sell the product Z that FP manufactures using the manufacturing method or process. The know-how consists entirely of manufacturing know-how used to implement the manufacturing steps that comprise the manufacturing method or process. DC licenses the worldwide rights to the patents, know-how, and the trademark and tradename for product Z to FP in exchange for annual royalties of 60 percent of revenue from sales of product Z. FP manufactures product Z in country X and sells product Z to DC2, a domestic corporation and unrelated party to DC and FP, for resale to customers located within the United States. FP also sells product Z to FP2, a foreign unrelated party with respect to DC and FP, for resale to customers located outside the United States. During the taxable year, FP sells to DC2 $140x of product Z. Also, during the taxable year, FP sells to FP2 $60x of product Z. DC determines under the principles of section 482 that the licensed know-how and the patented manufacturing method or process comprise 10 percent of the arm's length price of the intangible property DC licenses to FP.

(*ii*) *Analysis*—(A) *End users*. Under paragraph (d)(2)(ii)(C)(*1*) of this section, FP is treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process, and is treated as located outside the United States because FP is a foreign unrelated party and DC does not know or have reason to know that the patented process and know-how will be used in the United States. DC2, FP, and FP2 are not the end users of the remaining intangible property under paragraph (d)(2)(ii)(A) of this section because that intangible property is used in the sale of general property (the sale of product Z) and DC2, FP, and FP2 are not the end users of that general property. The unrelated party customers that purchase product Z from DC2 and FP2 are the end users (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because those customers are the unrelated party recipients of product Z.

(B) *Foreign use*. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the intangible property other than the manufacturing method or process is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. FP2 is a reseller of product Z to end users outside the United States, so all sales of product Z to FP2 are for a foreign use under paragraph (d)(1)(ii)(C) of this section. Because DC has determined that 10 percent of the value of the intangible property consists of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(*3*) of this section) used to manufacture product Z, $12x of the $120x royalty FP pays to DC during the taxable year is for foreign use ($120x total royalty × 0.10) based on the location of FP's manufacturing utilizing the know-how or all of the sequence of actions that comprise the manufacturing method or process under paragraph (d)(2)(ii)(C)(*3*) of this section. Based on the sales of product Z within and outside the United States, $32.4x of the royalties FP pays DC for rights to the licensed intangible property during the taxable year (($60x of revenue from sales to FP2 for resale to customers located outside the United States divided by $200x total worldwide sales revenue FP receives from DC2 and FP2) × ($120x total royalties less $12 of those royalties attributable to the manufacturing method or process)) qualifies as income earned from the sale of intangible property for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. As a result, $44.40x of royalties ($12x + $32.40x) is included in DC's gross FDDEI for the taxable year.

(*7*) *Example 7: License of intangible property that includes a patented manufacturing method or process protected in the United States and other countries; foreign related party with third-party manufacturer*—(*i*) *Facts*. The facts are the same as in paragraph (d)(2)(iv)(B)(*6*)(*i*) of this section (the facts in *Example 6*), except that FP is a foreign related party with respect to DC and FP engages FP2, a foreign unrelated party, to manufacture product Z. FP sublicenses to FP2 the rights to the intangible property FP licenses from DC solely to manufacture product Z and sell product Z to FP. FP2 manufactures product Z in country Y and sells all of product Z it manufactures to FP. During the taxable year, FP sold $80x of product Z to DC2, which DC2 resold to customers located within the United States. Also, during the taxable year, FP sold $120x of product Z to customers located outside the United States.

(*ii*) *Analysis*—(A) *End users*. Under paragraph (d)(2)(ii)(C)(*1*) of this section, FP is not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process because FP is a foreign related party with respect to DC. Under paragraph (d)(2)(ii)(C)(*2*) of this section, FP2 is also not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process because FP2 is using that intangible property to manufacture product Z for FP. DC2 is also not treated as the end user of the patent covering the right to use the manufacturing process and the manufacturing know-how used to implement the manufacturing method or process because DC2 does not use the patent or know-how in manufacturing. DC2, FP, and FP2 are not the end users of the remaining intangible property under paragraph (d)(2)(ii)(A) of this section because that intangible property is used in the sale of general property (the sale of product Z) and DC2, FP, and FP2 are not the end users of that general property. The unrelated party customers that purchase the Product Z from DC2 and FP are the end users (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because those customers are the persons that ultimately use or consume product Z.

(B) *Foreign use*. Based on the sales of product Z to customers located within and outside the United States, $72x of the royalties FP pays DC for rights to the licensed intangible property during the taxable year (($120x of revenue from sales to customers located outside the United States divided by $200x total worldwide sales revenue) × $120x total royalties) qualifies as income earned from the sale of intangible property for a foreign use under paragraph (d)(2) of this section and therefore such portion is a FDDEI sale. As a result, $72x of royalties is included in DC's gross FDDEI for the taxable year.

(*8*) *Example 8: Deemed sale in exchange for contingent payments under section 367(d)*—(*i*) *Facts.* DC owns 100 percent of the stock of FP, a foreign related party with respect to DC. FP manufactures and sells product A. For the taxable year, DC contributes to FP exclusive worldwide rights to patents, trademarks, know-how, customer lists, and goodwill and going concern value (collectively, intangible property) related to product A in an exchange described in section 351. DC is required to report an annual income inclusion on its Federal income tax return based on the productivity, use, or disposition of the contributed intangible property under section 367(d). DC includes a percentage of FP's revenue in its gross income under section 367(d) each year. In the current taxable year, FP earns $1,000x of revenue from sales of product A. Based on reliable sales records kept by FP for the taxable year, $300x of FP's revenue is earned from sales of product A to customers within the United States, and $700x of its revenue is earned from sales of product A to customers outside the United States.

(*ii*) *Analysis.* DC's deemed sale of the intangible property to FP in exchange for payments contingent upon the productivity, use, or disposition of the intangible property related to product A under section 367(d) is a sale for purposes of section 250 and this section. See §1.250(b)–3(b)(16). Based on FP's sales records for the taxable year, 70 percent of DC's deemed sale to FP is for a foreign use, and 70 percent of DC's income inclusion under section 367(d) derived with respect to such portion is included in DC's gross FDDEI for the taxable year.

(*9*) *Example 9: License of intangible property followed by a sale of general property in which the intangible property is embedded; unrelated parties*—(*i*) *Facts.* DC owns the worldwide rights to a patent on a silicon chip used in computers, tablets, and smartphones. The patent does not qualify as a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(*3*) of this section). DC licenses the worldwide rights to the patent to FP in exchange for annual royalties of 30 percent of revenue from sales of the silicon chips. During the taxable year, FP manufactures silicon chips protected by the patent and sells all of those chips to FP2 for $1,000x. FP2 also purchases similar silicon chips from other suppliers. FP2 uses the silicon chips in computers, tablets, smartphones, and motherboards that FP2 manufactures in country X and sells to its customers located within the United States and foreign countries. For purposes of this example, FP2's manufacturing qualifies as subjecting the silicon chips to manufacture, assembly, or other processing outside the United States as provided in paragraph (d)(1)(iii) of this section.

(*ii*) *Analysis.* FP is not the end user or treated as an end user (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because FP is not the unrelated party recipient of the general property in which the patent is embedded, and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. Because FP2 is subjecting the silicon chips to manufacture, assembly, or other processing outside the United States, the revenue from royalties FP pays to DC qualifies for foreign use based on the location of FP2's manufacturing and qualifies as a FDDEI sale. As a result, the entire $300x of annual royalties paid by FP to DC during the taxable year is included in DC's gross FDDEI for the taxable year.

(*10*) *Example 10: License of intangible property followed by a sale of general property in which the intangible property is embedded; related parties*—(*i*) *Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(*9*)(*i*) of this section (the facts in *Example 9*), except that FP and FP2 are foreign related parties with respect to DC. FP2 sells and ships computers, tablets, and smartphones it manufactures with the silicon chips it purchases from FP to unrelated party wholesalers located within and outside the United States. The wholesalers within the United States only sell to retailers located within the United States and the wholesalers outside the United States only sell to retailers located outside the United States. The retailers within the United States only sell to customers located within the United States and the retailers located outside the United States only sell to customers located outside the United States. FP2 earns $15,000x of revenue from sales to unrelated party wholesalers located outside the United States and $10,000x of revenue from sales to unrelated party wholesalers located within the United States. FP2 also sells and ships motherboards with the silicon chips it purchases from FP to unrelated party manufacturers located outside the United States. FP2 does not sell motherboards with the silicon chips it purchases from FP to unrelated party manufacturers located within the United States. FP2 earns $5,000x of revenue from the sales of these motherboards to manufacturers located outside the United States. For purposes of this example, these manufacturers subject the motherboards to manufacture, assembly, or other processing outside the United States as provided in paragraph (d)(1)(iii) of this section.

(*ii*) *Analysis.* FP is not the end user or treated as an end user (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP is not the end user of the general property in which the patent is embedded (the silicon chips). FP2 is also not the end user (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) of the intangible property because FP2 is not the end user of the silicon chips. Under paragraph (d)(2)(ii)(A) of this section, the customers of the retailers that purchase from the unrelated party wholesalers are the end users. Because the wholesalers located outside the United States only sell to retailers located outside the United States that sell to end users located outside the United States, the location of the wholesalers is a reliable basis for determining the location of the end users. Revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. A portion of the sales to the unrelated party wholesalers qualify as foreign use under paragraph (d)(1) of this section and the sales to the unrelated party manufacturers qualify as foreign use under paragraph (d)(1)(iii) of this section. Accordingly, revenue from royalties FP pays to DC is from a FDDEI sale to the extent of such sales to the unrelated party manufacturers and such portion of sales to unrelated party wholesalers that qualify for foreign use. As a result, $200x of annual royalties paid by FP to DC during the taxable year ((($15,000x of sales to wholesalers located outside the United States plus $5,000x of sales to manufacturers located outside the United States) divided by $30,000x total sales) × $300x) is included in DC's gross FDDEI for the taxable year.

(*11*) *Example 11: License of intangible property followed by a sale of general property that incorporates the intangible property; unrelated parties with manufacturing within the United States*—(*i*) *Facts.* The facts are the same as in paragraph (d)(2)(iv)(B)(*9*)(*i*) of this section (the facts in *Example 9*), except that FP2 manufactures its computers, tablets, smartphones, and motherboards in the United States.

(*ii*) *Analysis.* FP is not the end user or treated as an end user (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(A) of this section) because FP is not the unrelated party recipient of the general property in which the patent is embedded (the silicon chips) and the patent does not qualify as a manufacturing method or process. Under paragraph (d)(2)(ii)(A) of this section, revenue from royalties paid for the patent is earned from end users outside the United States to the extent the sale of the general property is for a foreign use under paragraph (d)(1) of this section. Because FP2 is subjecting the silicon chips to manufacture, assembly, or other processing within the United States, the revenue from royalties FP pays to DC does not qualify as foreign use based on the location of FP2's manufacturing and therefore does not qualify as a FDDEI sale. As a result, none of the $300x of annual royalties paid by FP to DC during the taxable year is included in DC's gross FDDEI for the taxable year.

(*12*) *Example 12: License of intangible property used to provide a service*—(*i*) *Facts*. DC licenses to FP worldwide rights to the copyrights on movies in exchange for an annual royalty of $100x. FP also licenses copyrights on movies from persons other than DC. FP provides a streaming service that meets the definition of an electronically supplied service in §1.250(b)–5(c)(5) to its customers within the United States and foreign countries. FP's streaming service provides its customers a catalog of movies to choose to stream. These movies include the copyrighted movies FP licenses from DC. FP does not provide DC with data showing how much revenue FP earned from streaming services during the taxable year, even after DC requests that FP provide it with such information. DC also is unable to determine how much revenue FP earned from streaming services to customers within the United States from the data it has with respect to FP and publicly available data with respect to FP. However, DC's economic analysis of the revenue DC expected it could earn annually from use of the copyrights as part of determining the annual payments DC would receive from FP from the license of the copyrights supports a determination that $10,000x of revenue would be earned during the taxable year from customers worldwide, and that 40 percent of that revenue would be earned from customers located outside the United States. During an examination of DC's return for the taxable year, DC provides the IRS with data explaining the economic analysis, inputs, and results from its valuation of the copyrights used in determining the amount of annual payments agreed to by DC and FP.

(*ii*) *Analysis*. Under paragraph (d)(2)(ii)(B) of this section, FP's customers are the end users of the copyrights FP licenses from DC because FP uses those copyrights to provide the general service to FP's customers. Under paragraph (d)(2)(ii)(B) of this section, revenue from royalties paid for the copyrights is earned from end users outside the United States to the extent the service qualifies as a FDDEI service under §1.250(b)–5. DC is allowed to use reliable economic analysis to estimate revenue earned by FP from streaming the licensed movies under paragraph (d)(2)(iii)(A) of this section because DC was unable to obtain actual revenue earned by FP from use of the copyrights during the taxable year after reasonable efforts to obtain the actual revenue data. Based on DC's reliable economic analysis, $40x of the annual royalty payment to DC ($0.40 \times$ $100x total annual royalty payment) is included in DC's gross FDDEI for the taxable year.

(*13*) *Example 13: License of intangible property used in research and development of other intangible property*— (*i*) *Facts*. DC owns a patent (''patent A'') for an active pharmaceutical ingredient (''API'') approved for treatment of disease A in the United States and in foreign countries. DC licenses to FP worldwide rights to patent A for an annual royalty of $100x. FP uses patent A in research and development of a new API for treatment of disease B. Patent A does not consist of a manufacturing method or process (as defined in paragraph (d)(2)(ii)(C)(*3*) of this section). FP's research and development is successful, resulting in FP obtaining both a patent for the new API for treatment of disease B and approval for use in the United States and foreign countries. FP does not earn any revenue from sales of finished pharmaceutical products containing the API during years 1 through 4 of the license of patent A. In year 5 of the license of patent A, FP earns $800x of revenue from sales of finished pharmaceutical products containing the API to customers located within the United States and $200x of revenue from sales to customers located in foreign countries.

(*ii*) *Analysis*. FP is not the end user (as defined in §1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(D) of this section) of patent A because FP is not the end user described in paragraph (d)(2)(ii)(A) of this section of the product in which the API that was developed from patent A is embedded. The unrelated party customers that purchase the finished pharmaceutical product from FP are the end users (as defined in § 1.250(b)–3(b)(2) and paragraph (d)(2)(ii)(D) of this section) because those customers are the end users described in paragraph (d)(2)(ii)(A) of this section of the pharmaceutical product in which the newly developed patent is embedded. During the taxable years that include years 1 through 4 of the license of patent A, FP earns no revenue from sales of the API to a foreign person for a foreign use. Under paragraph (d)(2)(ii)(D) of this section, none of the $100x annual royalty payments to DC for each of the tax years that include years 1 through 4 of the license of patent A is included in DC's gross FDDEI. Based on FP's sales of the API during the tax year that includes year 5 of the license of patent A, $20x of the annual royalty payment to DC ($200x of revenue from sales of API to customers located outside the United States divided by $1,000x total worldwide revenue earned from sales of the API) × $100x annual royalty) is included in DC's gross FDDEI for the taxable year.

(3) *Foreign use substantiation for certain sales of property*—(i) *In general*. Except as provided in § 1.250(b)–3(f)(3) (relating to certain loss transactions), a sale of property described in paragraphs (d)(1)(ii)(C) of this section (foreign use for sale of general property for resale), (d)(1)(iii) of this section (foreign use for sale of general property subject to manufacturing, assembly, or processing outside the United States), or (d)(2) of this section (foreign use for sale of intangible property) is a FDDEI transaction only if the taxpayer satisfies the substantiation requirements described in paragraphs (d)(3)(ii), (iii), or (iv) of this section, as applicable.

(ii) *Substantiation of foreign use for resale*. A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(ii)(C) of this section (sales of general property for resale) only if the seller maintains one or more of the following items—

(A) A binding contract that specifically limits subsequent sales to sales outside the United States;

(B) Proof that property is specifically designed, labeled, or adapted for a foreign market;

(C) Proof that the cost of shipping the property back to the United States relative to the value of the property makes it impractical that the property will be resold in the United States;

(D) Credible evidence obtained or created in the ordinary course of business from the recipient evidencing that property will be sold to an end user outside the United States (or, in the case of sales of fungible mass property, stating what portion of the property will be sold to end users outside the United States); or

(E) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(ii)(E)(*1*) through (*7*) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(*1*) The name and address of the recipient;

(*2*) The date or dates the property was shipped or delivered to the recipient;

(*3*) The amount of gross income from the sale;

(*4*) A full description of the property subject to resale;

(*5*) A description of the method of sales to the end users, such as direct sales by the recipient or sales by the recipient to retail stores;

(*6*) If known, a description of the end users; and

(*7*) A description of how the seller determined that property will be ultimately sold to an end user outside the United States (or, in the case of sales of fungible mass property, of how the taxpayer determined what portion of the property that will ultimately be sold to end users outside the United States).

(iii) *Substantiation of foreign use for manufacturing, assembly, or other processing outside the United States*. A seller satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(1)(iii) of this section (sales of general property subject to manufacturing, assembly, or other processing outside the United States) if the seller maintains one or more of the following items—

(A) Credible evidence that the property has been sold to a foreign unrelated party that is a manufacturer and such property generally cannot be sold to end users without being subject to a physical and material change (for example, the sale of raw materials that cannot be used except in a manufacturing process);

(B) Credible evidence obtained or created in the ordinary course of business from the recipient to support that the product purchased will be subject to manufacture, assembly, or other processing outside the United States within the meaning of paragraph (d)(1)(iii) of this section; or

(C) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iii)(C)(*1*) through (*7*) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(*1*) The name and address of the manufacturer of the property;

(*2*) The date or dates the property was shipped or delivered to the recipient;

(*3*) The amount of gross income from the sale;

(*4*) A full description of the general property sold and the type or types of finished goods that will incorporate the general property the taxpayer sold;

(*5*) A description of the manufacturing, assembly, or other processing operations, including the location or locations of manufacture, assembly, or other processing; how the general property will be used in the finished good; and the nature of the finished good's manufacturing, assembly, or other processing operations as compared to the process used to make the general property used to make the finished good;

(*6*) A description of how the seller determined the general property was substantially transformed or the activities were substantial in nature within the meaning of paragraph (d)(1)(iii)(B) or (C) of this section, whichever the case may be; and,

(*7*) If the seller is relying on the rule described in paragraph (d)(1)(iii)(C) of this section (that the fair market value of the general property be no more than twenty percent of the fair market value when incorporated into the finished goods sold to end users), an explanation of how the seller satisfies the requirements in that paragraph.

(iv) *Substantiation of foreign use of intangible property.* A taxpayer satisfies the substantiation requirements with respect to a sale of property described in paragraph (d)(2) of this section (foreign use for intangible property) if the seller maintains one or more of the following items—

(A) A binding contract that specifically provides that the intangible property can be exploited solely outside the United States;

(B) Credible evidence obtained or created in the ordinary course of business from the recipient establishing the portion of its revenue for a taxable year that was derived from exploiting the intangible property outside the United States; or

(C) A written statement prepared by the seller containing the information described in paragraphs (d)(3)(iv)(C)(*1*) through (*9*) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(*1*) The name and address of the recipient;

(*2*) The date of the sale;

(*3*) The amount of gross income from the sale;

(*4*) A description of the intangible property;

(*5*) An explanation of how the intangible property will be used by the recipient (embedded in general property, used to provide a service, used as a manufacturing method or process, or used in research and development);

(*6*) An explanation of how the seller determined what portion of the sale is a FDDEI sale;

(*7*) If the intangible property consists of a manufacturing method or process, an explanation of how the elements of paragraph (d)(2)(ii)(C) of this section are satisfied;

(*8*) If the sale is for periodic payments, an explanation of how the seller determined the extent of foreign use based on the actual revenue earned by the recipient from the use of the intangible property for the taxable year in which a periodic payment is received as required by paragraph (d)(2)(iii)(A) of this section, or, if actual revenue cannot be obtained after reasonable efforts, an explanation of why actual revenue is unavailable and how the seller determined the extent of foreign use based on estimated revenue; and

(*9*) If the sale is for a lump sum, an explanation of how the seller determined the total net present value of revenue it expected to earn from the exploitation of the intangible property outside the United States and the total net present value of revenue it expected to earn from the exploitation of the intangible property as required by paragraph (d)(2)(iii)(B) of this section.

(v) *Examples.* The following examples illustrate the application of this paragraph (d)(3).

(A) *Assumed facts.* The following facts are assumed for purposes of the examples—

(*1*) DC is a domestic corporation.

(*2*) FP is a foreign person located within Country A that is a foreign unrelated party with respect to DC.

(*3*) All of DC's income is DEI.

(*4*) Except as otherwise provided, the substantive rule for foreign use as described in paragraphs (d)(1) and (2) of this section are satisfied.

(B) *Examples*—

(*1*) *Example 1: Substantiation by seller of sale of products to distributor outside the United States with taxpayer statement and corroborating evidence*—(*i*) *Facts.* DC sells smartphones to FP, a distributor of electronics that sells property to end users. As part of their regular business process and pursuant to DC's terms and conditions of sales, DC issues commercial invoices to FP that contain a condition that any subsequent sales must be to end users outside the United States. At or near the time of the FDII filing date, DC prepares a statement containing the information required in paragraph (d)(3)(ii)(E) of this section. During an examination of DC's return for the taxable year, the IRS requests substantiation information of foreign use. DC submits the commercial invoices issued to FP as supporting information that FP's customers are end users outside the United States and all other corroborating evidence to the IRS.

(*ii*) *Analysis.* DC's sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirement by providing the statement that satisfies the requirements of paragraph (d)(3)(ii)(E) of this section. The commercial invoices issued pursuant to the terms and conditions of sales sufficiently corroborate DC's statement that the smartphones will ultimately be sold to end users outside of the United States.

(*2*) *Example 2: Substantiation of sale of products to distributor outside the United States with recipient provided information*—(*i*) *Facts.* DC sells cameras to FP, a distributor of electronics that sells property to end users outside the United States. FP issues sales invoices to its end users. The invoices contain detailed information about the nature of the subsequent sales of the cameras and the location of the end users for value added tax (VAT) purposes. DC is able to obtain copies of FP's VAT invoices with respect to the camera sales that were maintained and submitted pursuant to Country A law. Rather than prepare a statement described in paragraph (d)(3)(ii)(E) of this section, DC submits FP's invoices to the IRS as substantiation of foreign use.

(*ii*) *Analysis.* DC's sale to FP is a sale of general property for resale subject to the substantiation requirements of paragraph (d)(3)(ii) of this section. DC satisfies the substantiation requirements by providing the invoices that satisfy the requirements of paragraph (d)(3)(ii)(D) of this section. The VAT invoices issued by FP pursuant to Country A law constitute credible evidence from FP that ultimate sales are to end users located outside the United States.

(e) *Sales of interests in a disregarded entity.* Under Federal income tax principles, the sale of any interest in an entity that is disregarded for Federal income tax purposes is considered the sale of the assets of that entity, and this section applies to the sale of each such asset that is general property or intangible property for purposes of determining whether such sale qualifies as a FDDEI sale.

(f) *FDDEI sales hedging transactions*—(1) *In general.* The amount of a corporation's or partnership's gross FDDEI from FDDEI sales of general property in a taxable year is increased by any gain, or decreased by any loss, taken into account in that taxable year with respect to any FDDEI sales hedging transactions (determined by taking into account the applicable Federal income tax accounting rules, including § 1.446–4).

(2) *FDDEI sales hedging transaction*—The term *FDDEI sales hedging transaction* means a transaction that meets the requirements of § 1.1221–2(a) through (e) and that is identified in accordance with the requirements of § 1.1221–2(f), except that the transaction must manage risk of price changes or currency fluctuations with respect to ordinary property, as provided in § 1.1221–2(b)(1), and the ordinary property whose price risk is being hedged must be general property that is sold in a FDDEI sale.

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§ 1.250(b)–5 Foreign-derived deduction eligible income (FDDEI) services.

(a) *Scope.* This section provides rules for determining whether a provision of a service is a FDDEI service. Paragraph (b) of this section defines a FDDEI service. Paragraph (c) of this section provides definitions relevant for determining whether a provision of a service is a FDDEI service. Paragraph (d) of this section provides rules for determining whether a general service is provided to a consumer located outside the United States. Paragraph (e) of this section provides rules for determining whether a general service is provided to a business recipient located outside the United States. Paragraph (f) of this section provides rules for determining whether a proximate service is provided to a recipient located outside the United States. Paragraph (g) of this section provides rules for determining whether a service is provided with respect to property located outside the United States. Paragraph (h) of this section provides rules for determining whether a transportation service is provided to a recipient, or with respect to property, located outside the United States.

(b) *Definition of FDDEI service.* Except as provided in § 1.250(b)–6(d), the term *FDDEI service* means a provision of a service described in any one of paragraphs (b)(1) through (5) of this section. If only a portion of a service is treated as provided to a person, or with respect to property, outside the United States, the provision of the service is a FDDEI service only to the extent of the gross income derived with respect to such portion.

(1) The provision of a general service to a consumer located outside the United States (as determined under paragraph (d) of this section).

(2) The provision of a general service to a business recipient located outside the United States (as determined under paragraph (e) of this section).

(3) The provision of a proximate service to a recipient located outside the United States (as determined under paragraph (f) of this section).

(4) The provision of a property service with respect to tangible property located outside the United States (as determined under paragraph (g) of this section).

(5) The provision of a transportation service to a recipient, or with respect to property, located outside the United States (as determined under paragraph (h) of this section).

(c) *Definitions.* This paragraph (c) provides definitions that apply for purposes of this section and § 1.250(b)–6.

(1) *Advertising service.* The term *advertising service* means a general service that consists primarily of transmitting or displaying content (including via the internet) with a purpose to generate revenue based on the promotion of a product or service.

(2) *Benefit.* The term *benefit* has the meaning set forth in § 1.482–9(l)(3).

(3) *Business recipient.* The term *business recipient* means a recipient other than a consumer and includes all related parties of the recipient. However, if the recipient is a related party of the taxpayer, the term does not include the taxpayer.

(4) *Consumer.* The term *consumer* means a recipient that is an individual that purchases a general service for personal use.

(5) *Electronically supplied service.* The term *electronically supplied service* means, with respect to a general service other than an advertising service, a service that is delivered primarily over the internet or an electronic network and for which value of the service to the end user is derived primarily from automation or electronic delivery. Electronically supplied services include the provision of access to digital content (as defined in §1.250(b)–3), such as streaming content; on-demand network access to computing resources, such as networks, servers, storage, and software; the provision or support of a business or personal presence on a network, such as a website or a web page; online intermediation platform services; services automatically generated from a computer via the internet or other network in response to data input by the recipient; and similar services. Electronically supplied services do not include services that primarily involve the application of human effort by the renderer (not considering the human effort involved in the development or maintenance of the technology enabling the electronically supplied services). Accordingly, electronically supplied services do not include certain services (such as legal, accounting, medical, or teaching services) involving primarily human effort that are provided electronically.

(6) *General service.* The term *general service* means any service other than a property service, proximate service, or transportation service. The term *general service* includes advertising services and electronically supplied services.

(7) *Property service.* The term *property service* means a service, other than a transportation service, provided with respect to tangible property, but only if substantially all of the service is performed at the location of the property and results in physical manipulation of the property such as through manufacturing, assembly, maintenance, or repair. Substantially all of a service is performed at the location of property only if the renderer spends more than 80 percent of the time providing the service at or near the location of the property.

(8) *Proximate service.* The term *proximate service* means a service, other than a property service or a transportation service, provided to a consumer or business recipient, but only if substantially all of the service is performed in the physical presence of the consumer or, in the case of a business recipient, substantially all of the service is performed in the physical presence of persons working for the business recipient such as employees, contractors, or agents. Substantially all of a service is performed in the physical presence of a consumer or persons working for a business recipient only if the renderer spends more than 80 percent of the time providing the service in the physical presence of such persons.

(9) *Transportation service.* The term *transportation service* means a service to transport a person or property using aircraft, railroad rolling stock, vessel, motor vehicle, or any other mode of transportation. Transportation services include freight forwarding and similar services.

(d) *General services provided to consumers*—(1) *In general.* A general service is provided to a consumer located outside the United States if the consumer of a general service resides outside of the United States when the service is provided. Except as provided in paragraph (d)(2) of this section, if the renderer does not have or cannot after reasonable efforts obtain the consumer's location of residence when the service is provided, the consumer of a general service is treated as residing at the location of the consumer's billing address. However, the rule in the preceding sentence allowing for the use of a consumer's billing address does not apply if the renderer knows or has reason to know that the consumer does not reside outside the United States. A renderer has reason to know that the consumer does not reside outside the United States if the information received as part of the provision of the service indicates that the consumer resides in the United States and the renderer fails to obtain evidence establishing that the consumer resides outside the United States.

(2) *Electronically supplied services.* The consumer of an electronically supplied service is deemed to reside at the location of the device used to receive the service. Such location may be determined based on the location of the IP address when the electronically supplied service is provided. However, if the renderer does not have or cannot after reasonable efforts obtain the consumer's device location, then the location of the device is treated as being outside the United States if the renderer's billing address for the consumer is outside of the United States, subject to the knowledge and reason to know standards described in paragraph (d)(1) of this section.

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

(i) *Facts.* DC, a domestic corporation, provides a streaming movie service on its website. The terms of the service allow consumers to watch movies over the internet. The terms of the service permit the consumer to view the movies for personal use, but convey no ownership of movies to the consumers.

(ii) *Analysis.* The streaming service is a FDDEI service under paragraph (d)(1) of this section to the extent that the service is provided to consumers that reside outside the United States. The service that DC provides is a general service, provided to consumers that is an electronically supplied service under paragraph (c)(5) of this section. Therefore, the consumers are deemed to reside at the location of the devices used to receive the service under paragraph (d)(2) of this section. However, if the renderer cannot reasonably obtain the consumers' device location (such as IP addresses), the device location is treated as being outside the United States if their billing addresses are outside the United States. See §1.250(b)–4(d)(1)(v)(B)(*7*) for an example of digital content provided to consumers as a sale rather than a service.

(e) *General services provided to business recipients*—(1) *In general.* A general service is provided to a business recipient located outside the United States to the extent that the service confers a benefit on the business recipient's operations outside the United States under the rules in paragraph (e)(2) of this section. The location of residence, incorporation, or formation of a business recipient is not relevant to determining the location of the business recipient's operations that benefit from a general service.

(2) *Determination of business operations that benefit from the service*—(i) *In general.* Except as otherwise provided in paragraph (e)(2)(ii) and (iii) of this section, the determination of which operations of the business recipient located outside the United States benefit from a general service, and the extent to which such operations benefit, is made under the principles of §1.482–9 by treating the taxpayer as one controlled taxpayer, the portions of the business recipient's operations within the United States (if any) that may benefit from the general service as one or more controlled taxpayers, and the portions of the business recipient's operations outside the United States (if any) that may benefit from the general service, each as one or more controlled taxpayers. The extent to which a business recipient's operations within or outside of the United States are treated as one or more separate controlled taxpayers is determined under any reasonable method (for example, separate controlled taxpayers may be determined on a per entity or per country basis, or by aggregating all of the business recipient's operations outside the United States as one controlled taxpayer). The determination of the amount of the benefit conferred on the business recipient's operations that are treated as controlled taxpayers is determined under a reasonable method consistent with the principles of §1.482–9(k), treating the renderer's gross income from the services provided to the business recipient as if it were a ''cost'' as that term is used in §1.482–9(k). Reasonable methods may include, for example, allocations based on time spent or costs incurred by the renderer or sales, profits, or assets of the business recipient. The determination is made when the service is provided based on information obtained from the business recipient or on the renderer's own records (such as time spent working with the business recipient's offices located outside the United States).

(ii) *Advertising services.* With respect to advertising services, the operations of the business recipient that benefit from the advertising service provided by the renderer are deemed to be located where the advertisements are viewed by individuals. If advertising services are displayed via the internet, the advertising services are viewed at the location of the device on which the advertisements are viewed. For this purpose, the IP address may be used to establish the location of a device on which an advertisement is viewed.

(iii) *Electronically supplied services.* With respect to an electronically supplied service, the operations of the business recipient that benefit from that service provided by the renderer are deemed to be located where the business recipient (including employees, contractors, or agents) accesses or otherwise uses the service. If it cannot be determined whether the location is within or outside the United States (such as where the location of access cannot be reliably determined using the location of the IP address of the device used to receive the service), and the gross receipts from all services with respect to the business recipient are in the aggregate less than $50,000 for the renderer's taxable year, the operations of the business recipient that benefit from the service provided by the renderer are deemed to be located at the recipient's billing address; otherwise, the operations of the business recipient that benefit are deemed to be located in the United States. If the renderer provides a service that is partially an electronically supplied service and partially a general service that is not an electronically supplied service (such as a service that is performed partially online and partially by mail or in person), the location of the business recipient is determined using the rule for electronically supplied services in this paragraph (e)(2)(iii) if the primary purpose of the service is to provide electronically supplied services; otherwise, the rule for general services described in paragraph (e)(2)(i) of this section applies.

(3) *Identification of business recipient's operations*—(i) *In general.* For purposes of this paragraph (e), except with respect to advertising services and electronically supplied services, a business recipient is treated as having operations where it maintains an office or other fixed place of business. In general, an office or other fixed place of business is a fixed facility, that is, a place, site, structure, or other similar facility, through which the business recipient engages in a trade or business. For purposes of making the determination in this paragraph (e)(3)(i), the renderer may make reliable assumptions based on the information available to it.

(ii) *Advertising services and electronically supplied services.* The location of a business recipient that receives advertising services or electronically supplied services will be determined under the rules of paragraph (e)(2)(ii) and (iii) of this section, respectively, even if the business recipient does not maintain an office or other fixed place of business in the locations where the advertisements are viewed (in the case of advertising services) or where the general service is accessed (in the case of electronically supplied services).

(iii) *No office or fixed place of business.* In the case of general services other than advertising services and other than electronically supplied services, if the business recipient does not have an identifiable office or fixed place of business (including the office of a principal manager or managing owner), the business recipient is deemed to be located at its primary billing address.

(4) *Substantiation of the location of a business recipient's operations outside the United States.* Except as provided in §1.250(b)–3(f)(3) (relating to certain loss transactions), a general service provided to a business recipient is treated as a FDDEI service only if the renderer substantiates its determination of the extent to which the service benefits a business recipient's operations outside the United States. A renderer satisfies the preceding sentence if the renderer maintains one or more of the following items—

(i) Credible evidence obtained or created in the ordinary course of business from the business recipient establishing the extent to which operations of the business recipient outside the United States benefit from the service; or

(ii) A written statement prepared by the renderer containing the information described in paragraphs (e)(4)(ii)(A) through (F) of this section corroborated by evidence that is credible and sufficient to support the information provided.

(A) The name of the business recipient;

(B) The date or dates of the service;

(C) The amount of gross income from the service;

(D) A full description of the service;

(E) A description of how the service will benefit the business recipient; and

(F) An explanation of how the renderer determined what portion of the service will benefit the business recipient's operations located outside the United States.

(5) *Examples*. The following examples illustrate the application of this paragraph (e).

(i) *Assumed facts*. The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.

(B) A and R are not related parties of DC.

(C) Except as otherwise provided, the substantiation requirements described in paragraph (e)(4) of this section are satisfied.

(ii) *Examples—*

(A) *Example 1: Determination of business operations that benefit from the service—*(*1*) *Facts*. For the taxable year, DC provides a consulting service to R, a company that operates restaurants within and outside of the United States, in exchange for $150x. Fifty percent of the sales earned by R and its related parties are from customers located outside of the United States. However, the consulting service that DC provides relates specifically to a single chain of fast food restaurants that R operates. Sales information that R provides to DC indicates that 70 percent of the sales of the fast food restaurant chain are from locations within the United States and 30 percent of the sales are from Country X. DC determines that the use of sales is a reasonable method under the principles of §1.482–9(k) to allocate the benefit of the consulting service among R's fast food operations.

(*2*) *Analysis*. Under paragraph (e)(1) of this section, DC's service is provided to a person located outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. Under paragraph (e)(2)(i) of this section, DC, R's fast food operations within the United States, and R's fast food operations in Country X, are treated as if they were controlled taxpayers because only these operations may benefit from DC's service. The principles of §1.482–9(k) apply to determine the amount of DC's service that benefits R's operations outside the United States. DC's gross income is allocated based on the sales of the fast food chain of restaurants that benefits from DC's service because using sales is a reasonable method. Therefore, 30 percent of the provision of the consulting service is treated as the provision of a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, $45x ($150x × 0.30) of DC's gross income from the provision of the consulting service is included in DC's gross FDDEI for the taxable year.

(B) *Example 2: Determination of business operations that benefit from the service; alternative facts—*(*1*) *Facts*. The facts are the same as in paragraph (e)(5)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that DC provides an information technology service to R that benefits R's entire business. DC determines that the use of sales is a reasonable method under the principles of §1.482–9(k) to allocate the benefit of the information technology service among R's entire business.

(*2*) *Analysis*. DC, R's operations within the United States, and R's operations in Country X, are treated as if they were controlled taxpayers because the service that DC provides relates to R's entire business. DC's gross income is allocated based on sales of the entire business because using sales is a reasonable method to determine the amount of DC's service that benefits R's operations outside the United States under the principles of §1.482–9(k). Therefore, 50 percent of the provision of the information technology service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, \$75x (\$150x × 0.50) of DC's gross income from the provision of the information technology service is included in DC's gross FDDEI for the taxable year.

(C) *Example 3: Advertising services*—(*1*) *Facts*. The facts are the same as in paragraph (e)(5)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that DC provides an advertising service to R. DC displays advertisements for R's restaurant chain on its social media website and smartphone application. Based on the IP addresses of the devices on which the advertisements are viewed, 20 percent of the views of the advertisements were from devices located outside the United States.

(*2*) *Analysis*. Because the service that DC provides is an advertising service, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(ii) of this section, R's operations that benefit from DC's advertising service are deemed to be where the advertisements are viewed. Therefore, 20 percent of the provision of the advertising service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section. Accordingly, \$30x (\$150x × 0.20) of DC's gross income from the provision of the advertising service is included in DC's gross FDDEI for the taxable year.

(D) *Example 4: No reliable information about which operations benefit from the service or publicly available information*—(*1*) *Facts*. For the taxable year, DC provides a consulting service to R, a business-facing company that does not advertise its business. All of DC's interaction with R is through R's employees that report to an office in the United States. Statements made by R's employees indicate that the service will benefit R's business operations located within and outside the United States, but do not provide information that would allow DC to reliably determine the extent to which its service will confer a benefit on R's business operations located outside the United States.

(*2*) *Analysis*. DC is unable to determine the extent to which its service will confer a benefit on R's business operations located outside the United States under paragraph (e)(2)(i) of this section. Accordingly, DC cannot substantiate a determination of the extent to which the service benefits a business recipient's operations outside the United States under paragraph (e)(4) of this section. Therefore, no portion of DC's service is a FDDEI service.

(E) *Example 5: Electronically supplied services that are accessed by the business recipient's employees*—(*1*) *Facts*. DC provides payroll services for R. As part of this service, DC maintains a website through which R can enter payroll information for its employees and through which R's employees can enter and change their personal information. DC also causes R's employees' paychecks to be directly deposited into their bank accounts and pays R's employment taxes on R's behalf. The primary purpose of the service is to pay R's employees. R has 100 user accounts that access DC's website. Sixty of the user accounts that access DC's website access the website from devices that are located outside the United States and forty of the user accounts access the website from devices that are located inside the United States.

(*2*) *Analysis*. Under paragraph (e)(1) of this section, DC's service is provided to a person located outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. The service that DC provides to R is an electronically supplied service under paragraph (c)(5) of this section. Accordingly, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(iii) of this section, R's operations that benefit from DC's services are deemed to be located where R accesses the service, which is where R's employees access the website. See paragraph (e)(2)(iii) of this section. Accordingly, the portion of the payroll service that is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section is determined based on the extent to which the locations where R accesses the website are located outside the United States. Because 60 percent (60/100) of user accounts access DC's website from locations outside the United States, 60 percent of the provision of the payroll service is treated as a service to a person located outside the United States and a FDDEI service under paragraph (b)(2) of this section.

(F) *Example 6: Electronically supplied services that are accessed by the business recipient's customers*— (*1*) *Facts*. DC maintains an inventory management website for R, a company that sells consumer goods online. R's offices and all of its employees, who use the website, are located in the United States, but R sells its products to customers both within and outside the United States.

(*2*) *Analysis*. Under paragraph (e)(1) of this section, DC's service is provided to a person located outside the United States to the extent that DC's service confers a benefit to R's operations outside the United States. The service that DC provides to R is an electronically supplied service under paragraph (c)(5) of this section. Accordingly, under paragraph (e)(2)(i) of this section, as modified by paragraph (e)(2)(iii) of this section, R's operations that benefit from DC's services are deemed to be located where the service is accessed by employees. Therefore, none of the provision of the inventory management website is treated as a service to a person located outside the United States and none is a FDDEI service under paragraph (b)(2) of this section.

(G) *Example 7: Service provided to a domestic person*—(*1*) *Facts*. A, a domestic corporation that operates solely in the United States, enters into a services agreement with R, a company that operates solely outside the United States. Under the agreement, A agrees to perform a consulting service for R. A hires DC to provide a service to A that A will use in the provision of a consulting service to R.

(*2*) *Analysis*. Because DC provides a service to A, a person located within the United States, DC's provision of the service to A is not a FDDEI service under paragraph (b)(2) of this section, even though the service is used by A in providing a service to R, a person located outside the United States. See also section 250(b)(5)(B)(ii). However, A's provision of the consulting service to R may be a FDDEI service, in which case A's gross income from the provision of such service would be included in A's gross FDDEI.

(f) *Proximate services*. A proximate service is provided to a recipient located outside the United States if the proximate service is performed outside the United States. In the case of a proximate service performed partly within the United States and partly outside of the United States, a proportionate amount of the service is treated as provided to a recipient located outside the United States corresponding to the portion of time the renderer spends providing the service outside of the United States.

(g) *Property services*—(1) *In general*. Except as provided in paragraph (g)(2) of this section, a property service is provided with respect to tangible property located outside the United States only if the property is located outside the United States for the duration of the period the service is performed.

(2) *Exception for services provided with respect to property temporarily in the United States*. A property service is deemed to be provided with respect to tangible property located outside the United States if the following conditions are satisfied—

(i) The property is temporarily in the United States for the purpose of receiving the property service;

(ii) After the completion of the service, the property will be primarily hangared, stored, or used outside the United States;

(iii) The property is not used to generate revenue in the United States at any point during the duration of the service; and

(iv) The property is owned by a foreign person that resides or primarily operates outside the United States.

(h) *Transportation services*. Except as provided in this paragraph (h), a transportation service is provided to a recipient, or with respect to property, located outside the United States only if both the origin and the destination of the service are outside of the United States. However, in the case of a transportation service provided to a recipient, or with respect to property, where either the origin or the destination of the service is outside of the United States, but not both, then 50 percent of the gross income from the transportation service is considered derived from services provided to a recipient, or with respect to property, located outside the United States.

[T.D. 9901, 85 FR 43080, July 15, 2020, as amended by 85 FR 60910, Sept. 29, 2020; 85 FR 68249, Oct. 28, 2020; T.D. 9959, 87 FR 324, Jan. 4, 2022]

§ 1.250(b)–6 Related party transactions.

(a) *Scope.* This section provides rules for determining whether a sale of property or a provision of a service to a related party is a FDDEI transaction. Paragraph (b) of this section provides definitions relevant for determining whether a sale of property or a provision of a service to a related party is a FDDEI transaction. Paragraph (c) of this section provides rules for determining whether a sale of general property to a foreign related party is a FDDEI sale. Paragraph (d) of this section provides rules for determining whether the provision of a general service to a business recipient that is a related party is a FDDEI service.

(b) *Definitions.* This paragraph (b) provides definitions that apply for purposes of this section.

(1) *Related party sale.* The term *related party sale* means a sale of general property to a foreign related party. See §1.250(b)–1(e)(3)(ii)(D) (*Example 4*) for an illustration of a related party sale in the case of a seller that is a partnership.

(2) *Related party service.* The term *related party service* means a provision of a general service to a business recipient that is a related party of the renderer and that is described in §1.250(b)–5(b)(2) without regard to paragraph (d) of this section.

(3) *Unrelated party transaction.* The term *unrelated party transaction* means, with respect to property purchased by a foreign related party (the "purchased property") in a related party sale from a seller—

(i) A sale of the purchased property by the foreign related party in the ordinary course of its business to a foreign unrelated party with respect to the seller;

(ii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property is a constituent part of the property sold to the foreign unrelated party;

(iii) A sale of property by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property is not a constituent part of the product sold to the foreign unrelated party but rather is used in connection with producing the property sold to the foreign unrelated party; or

(iv) A provision of a service by the foreign related party to a foreign unrelated party with respect to the seller, if the purchased property was used in connection with the provision of the service.

(c) *Related party sales*—(1) *In general.* A related party sale of general property is a FDDEI sale only if the requirements described in either paragraph (c)(1)(i) or (ii) of this section are satisfied with respect to the related party sale. This paragraph (c) does not apply in determining whether a sale of intangible property to a foreign related party is a FDDEI sale.

(i) *Sale of property in an unrelated party transaction.* A related party sale is a FDDEI sale if an unrelated party transaction described in paragraph (b)(3)(i) or (ii) of this section occurs with respect to the property purchased in the related party sale and such unrelated party transaction is described in §1.250(b)–4(b) (definition of FDDEI sale). The seller in the related party sale may establish that an unrelated party transaction will occur with respect to the property, or what portion of the property will be sold in an unrelated party transaction in the case of sale of a fungible mass of general property, based on contractual terms (including, for example, that the related party is contractually bound to only sell the product to foreign unrelated parties), past practices of the foreign related party (such as practices to only sell products to foreign unrelated parties), a showing that the product sold is designed specifically for a foreign market, or books and records otherwise evidencing that sales will be made to foreign unrelated parties.

(ii) *Use of property in an unrelated party transaction.* A related party sale is a FDDEI sale if one or more unrelated party transactions described in paragraph (b)(3)(iii) or (iv) of this section occurs with respect to the property purchased in the related party sale and such unrelated party transaction or transactions would be described in §1.250(b)–4(b) or §1.250(b)–5(b) (definition of FDDEI service). If the property purchased in the related party sale will be used in unrelated party transactions described in the preceding sentence and other transactions, the amount of gross income from the related party sale that is attributable to a FDDEI sale is equal to the gross income from the related party sale multiplied by a fraction, the numerator of which is the revenue that the related party reasonably expects (as of the FDII filing date) to earn from all unrelated party transactions with respect to the property purchased in the related party sale that would be described in §1.250(b)–4(b) or §1.250(b)–5(b) and the denominator of which is the total revenue that the related party reasonably expects (as of the FDII filing date) to earn from all transactions with respect to the property purchased in the related party sale.

(2) *Treatment of foreign related party as seller or renderer*. For purposes of determining whether a sale of property or provision of a service by a foreign related party is, or would be, described in §1.250(b)–4(b) or §1.250(b)–5(b), the foreign related party that sells the property or provides the service is treated as a seller or renderer, as applicable, and the foreign unrelated party is treated as the recipient.

(3) *Transactions between related parties*. For purposes of determining whether an unrelated party sale has occurred and satisfies the requirements of paragraphs (c)(1) or (2) of this section with respect to a sale to a foreign related party (and not for purposes of determining whether a sale is to a foreign person as required by §1.250(b)–4(b)), the seller and all related parties of the seller are treated as if they are part of a single foreign related party. For purposes of the preceding sentence, in determining whether a United States person is a member of the seller's modified affiliated group, and therefore a related party of the seller, the definition of the term *modified affiliated group* in §1.250(b)–1(c)(17) applies without the substitution of ''more than 50 percent'' for ''at least 80 percent'' each place it appears. Accordingly, if a foreign related party sells or uses property purchased in a related party sale in a transaction with a second related party of the seller, transactions between the second related party and an unrelated party may be treated as an unrelated party transaction for purposes of applying paragraph (c)(1) of this section to a related party sale.

(4) *Example*. The following example illustrates the application of this paragraph (c).

(i) *Facts*. DC, a domestic corporation, sells a machine to FC, a foreign related party of DC in a transaction described in §1.250(b)–4(b) (without regard to this paragraph (c)). FC uses the machine solely to manufacture product A. As of the FDII filing date for the taxable year, 75 percent of future revenue from sales by FC to unrelated parties of product A will be from sales that would be described in §1.250(b)–4(b).

(ii) *Analysis*. The sale by DC to FC is a related party sale. Because FC uses the machine to make product A, but the machine is not a constituent part of product A because FC does not undertake further manufacturing with respect to the machine itself, FC's sale of product A is an unrelated party transaction described in paragraph (b)(3)(iii) of this section. Therefore, DC's sale of the machine is only a FDDEI sale if the requirements of paragraph (c)(1)(ii) of this section are satisfied. Because 75 percent of the revenue from future sales of product A will be from unrelated party transactions that would be described in §1.250(b)–4(b), 75 percent of the revenues from DC's sale of the machine to FC constitute FDDEI sales.

(d) *Related party services*—(1) *In general*. Except as provided in this paragraph (d)(1), a related party service is a FDDEI service only if the related party service is not substantially similar to a service that has been provided or will be provided by the related party to a person located within the United States. However, if a related party service is substantially similar to a service provided (in whole or in part) by the related party to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the amount of gross income from the related party service attributable to a FDDEI service is equal to the difference between the gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service. Section 250(b)(5)(C)(ii) and this paragraph (d)(1) apply only to a general service provided to a related party that is a business recipient and are not applicable with respect to any other service provided to a related party.

(2) *Substantially similar services.* A related party service is substantially similar to a service provided by the related party to a person located within the United States only if the related party service is used by the related party in whole or part to provide a service to a person located within the United States and either—

(i) 60 percent or more of the benefits conferred by the related party service are directly used by the related party to confer benefits on consumers or business recipients located within the United States; or

(ii) 60 percent or more of the price paid by consumers or business recipients located within the United States for the service provided by the related party is attributable to the related party service.

(3) *Special rules.* For purposes of paragraph (d) of this section, the rules in paragraphs (d)(3)(i) and (ii) of this section apply.

(i) *Rules for determining the location of and price paid by recipients of a service provided by a related party.* The location of a consumer or business recipient with respect to services provided by the related party is determined under §1.250(b)–5(d) and (e)(2), respectively, but treating the related party as the renderer. Accordingly, if the related party provides a service to a business recipient, the related party is treated as conferring benefits on a person located within the United States to the extent that the service confers a benefit on the business recipient's operations located within the United States. Similarly, for purposes of applying paragraph (d)(2)(ii) of this section with respect to business recipients, the price paid by a business recipient to the related party for services is allocated proportionally based on the locations of the business recipient that benefit from the services provided by the related party.

(ii) *Rules for allocating the benefits provided by and price paid to the renderer of a related party service.* For purposes of applying paragraph (d)(2)(i) of this section with respect to benefits that are directly used by the related party to confer benefits on its recipients, the benefits provided by the renderer to the related party are allocated to the related party's consumers or business recipients within the United States based on the proportion of benefits conferred by the related party on consumers or business recipients located within the United States. For purposes of determining the amount of the price paid by persons located within the United States that is attributable to the related party service in applying paragraph (d)(2)(ii) of this section, if the related party provides services that confer benefits on persons located within the United States and outside the United States, the price paid for the related party service by the related party to the renderer is allocated proportionally based on the benefits conferred on each location by the related party to its recipients.

(4) *Examples.* The following examples illustrate the application of this paragraph (d).

(i) *Assumed facts.* The following facts are assumed for purposes of the examples—

(A) DC is a domestic corporation.

(B) FC is a foreign corporation and a foreign related party of DC that operates solely outside the United States.

(C) The service DC provides to FC is a general service provided to a business recipient located outside the United States as described in §1.250(b)–5(b)(2) without regard to the application of paragraph (d) of this section.

(D) The benefits conferred by DC's service to FC's customers are not indirect or remote within the meaning of §1.482–9(l)(3)(ii).

(ii) *Examples*—

(A) *Example 1: Services that are substantially similar services under paragraph (d)(2)(i) of this section*—(*1*) *Facts.* FC enters into a services agreement with R, a company that operates restaurant chains within and outside the United States. Under the agreement, FC agrees to furnish a design for the renovation of a chain of restaurants that R owns; the design will include architectural plans. FC hires DC to provide an architectural service to FC that FC will use in the provision of its design service to R. The architectural service that DC provides to FC will serve no other purpose than to enable FC to provide its service to R. The service that FC provides will benefit only R's operations within the United States. FC pays an arm's length price of $50x to DC for the architectural service and DC recognizes $50x of gross income from the service. FC incurs additional costs to add additional design elements to the plans and charges R a total of $100x for its service.

(*2*) *Analysis.* All of the service that DC provides to FC is directly used in the provision of a service to R because FC uses DC's architectural service to provide its design service to R, and the architectural service that DC provides to FC will serve no purpose other than to enable FC to provide its service to R. In addition, FC is treated as conferring benefits only to persons located within the United States under paragraph (d)(3)(i) of this section because only R's operations within the United States benefit from the service provided by FC that used the service provided by DC. Therefore, the service provided by DC to FC is substantially similar to the service provided by FC to R under paragraph (d)(2)(i) of this section. Accordingly, DC's provision of the architectural service to FC is not a FDDEI service under paragraph (d)(1) of this section, and DC's gross income from the architectural service ($50x) is not included in its gross FDDEI.

(B) *Example 2: Services that are not substantially similar services under paragraph (d)(2)(i) of this section*—(*1*) *Facts.* The facts are the same as paragraph (d)(4)(ii)(A)(*1*) of this section (the facts in *Example 1*), except that 90 percent of R's operations that will benefit from FC's service are located outside the United States.

(*2*) *Analysis*—(*i*) *Analysis under paragraph (d)(2)(i) of this section.* All of the service that DC provides to FC is directly used in the provision of a service to R. However, because 90 percent of R's operations that will benefit from FC's service are located outside the United States under paragraph (d)(3)(i) of this section, only 10 percent of the benefits of FC's service are conferred on persons located within the United States. Further, because FC's service confers a benefit on R's operations located within and outside the United States, the benefit provided by DC to FC is allocated proportionately based on the locations of R that benefit from the services provided by FC under paragraph (d)(3)(ii) of this section. Therefore, only 10 percent of DC's architectural service are directly used by FC to confer benefits on persons located within the United States under paragraph (d)(3)(ii) of this section. Therefore, the architectural service provided by DC to FC is not substantially similar to the design service provided by FC to persons located within the United States under paragraph (d)(2)(i) of this section.

(C) *Example 3: Services that are substantially similar services under paragraph (d)(2)(ii) of this section*—(*1*) *Facts.* The facts are the same as paragraph (d)(4)(ii)(B)(*1*) of this section (the facts in *Example 2*), except that FC pays an arm's length price of $75x to DC for the architectural service and DC recognizes $75x of gross income from the service. As in paragraph (d)(4)(ii)(A)(*1*) and (d)(4)(ii)(B)(*1*) of this section (the facts in *Example 1* and *Example 2*), FC charges R a total of $100x for its service.

(*2*) *Analysis*—(*i*) *Price paid by persons located within the United States.* Under paragraph (d)(3)(i) of this section, FC is treated as conferring benefits on a person located within the United States to the extent that R's operations that will benefit from FC's service are located within the United States. Further, because FC's service confers a benefit on R's operations located within and outside the United States, the price paid by R to FC ($100x) is allocated proportionately based on the locations of R that benefit from the services provided by FC under paragraph (d)(3)(i) of this section. Accordingly, because 10 percent of R's operations that will benefit from FC's services are located within the United States, persons located within the United States are treated as paying $10x ($100x × 0.10) for FC's services for purposes of applying the test in paragraph (d)(2)(ii) of this section.

(*ii*) *Amount attributable to the related party service.* The service that FC provides to R is attributable in part to DC's service because FC uses the architectural plans that DC provides to provide a service to R. Under paragraph (d)(3)(ii) of this section, because the benefits of the service provided by FC are conferred on persons located within the United States and outside the United States, a proportionate amount (10 percent) of the price paid to DC for the related party service ($75x), or $7.5x, is treated as attributable to the services provided to persons located within the United States.

(*iii*) *Application of test in paragraph (d)(2)(ii) of this section.* For purposes of applying the test described in paragraph (d)(2)(ii) of this section, the price paid by persons located within the United States for the service provided by the related party (FC) is $10x, as determined in paragraph (d)(4)(ii)(C)(*2*)(*i*) of this section (the analysis of this *Example 3*). The amount of the price that is attributable to DC's service is $7.5x, as determined in paragraph (d)(4)(ii)(C)(*2*)(*ii*) of this section (the analysis of this *Example 3*). Accordingly, of the price treated as paid to FC by persons located within the United States, 75 percent ($7.5x/$10x) is attributable to the related party service. Because more than 60 percent of the price treated as paid by persons within the United States for FC's service is attributable to DC's service, the service provided by DC to FC is substantially similar to the design service provided by FC to persons located within the United States under paragraph (d)(2)(ii) of this section.

(*iv*) *Conclusion.* Under paragraph (d)(1) of this section, because the related party service provided by DC is substantially similar to the service provided by FC to a person located in the United States solely by reason of paragraph (d)(2)(ii) of this section, the difference between DC's gross income from the related party service and the amount of the price paid by persons located within the United States that is attributable to the related party service is treated as a FDDEI service. Accordingly, $67.5x ($75x—$7.5x) of DC's gross income from the provision of the service to FC is treated as a FDDEI service.

[T.D. 9901, 85 FR 43080, July 15, 2020, as amended by 85 FR 60910, Sept. 29, 2020; 85 FR 68250, Oct. 28, 2020]

ITEMS NOT DEDUCTIBLE

§ 1.261–1 General rule for disallowance of deductions.

In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in Chapter 1 of the Code, in respect of any of the items specified in Part IX (section 262 and following), Subchapter B, Chapter 1 of the Code, and the regulations thereunder.

§ 1.262–1 Personal, living, and family expenses.

(a) *In general.* In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided in chapter 1 of the Code, for personal, living, and family expenses.

(b) *Examples of personal, living, and family expenses.* Personal, living, and family expenses are illustrated in the following examples:

(1) Premiums paid for life insurance by the insured are not deductible. See also section 264 and the regulations thereunder.

(2) The cost of insuring a dwelling owned and occupied by the taxpayer as a personal residence is not deductible.

(3) Expenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible. A taxpayer who rents a property for residential purposes, but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent. If, however, he uses part of the house as his place of business, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense.

(4) Losses sustained by the taxpayer upon the sale or other disposition of property held for personal, living, and family purposes are not deductible. But see section 165 and the regulations thereunder for deduction of losses sustained to such property by reason of casualty, etc.

(5) Expenses incurred in traveling away from home (which include transportation expenses, meals, and lodging) and any other transportation expenses are not deductible unless they qualify as expenses deductible under section 162 (relating to trade or business expenses), section 170 (relating to charitable contributions), section 212 (relating to expenses for production of income), section 213 (relating to medical expenses), or section 217 (relating to moving expenses), and the regulations under those sections. The taxpayer's costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses. For expenses paid or incurred before October 1, 2014, a taxpayer's expenses for lodging when not traveling away from home (local lodging) are nondeductible personal expenses. However, taxpayers may deduct local lodging expenses that qualify under section 162 and are paid or incurred in taxable years for which the period of limitation on credit or refund under section 6511 has not expired. For expenses paid or incurred on or after October 1, 2014, a taxpayer's local lodging expenses are personal expenses and are not deductible unless they qualify as deductible expenses under section 162. Except as permitted under section 162 or 212, the costs of a taxpayer's meals not incurred in traveling away from home are nondeductible personal expenses.

(6) Amounts paid as damages for breach of promise to marry, and attorney's fees and other costs of suit to recover such damages, are not deductible.

(7) Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.

(8) The cost of equipment of a member of the armed services is deductible only to the extent that it exceeds nontaxable allowances received for such equipment and to the extent that such equipment is especially required by his profession and does not merely take the place of articles required in civilian life. For example, the cost of a sword is an allowable deduction in computing taxable income, but the cost of a uniform is not. However, amounts expended by a reservist for the purchase and maintenance of uniforms which may be worn only when on active duty for training for temporary periods, when attending service school courses, or when attending training assemblies are deductible except to the extent that nontaxable allowances are received for such amounts.

(9) Expenditures made by a taxpayer in obtaining an education or in furthering his education are not deductible unless they qualify under section 162 and §1.162–5 (relating to trade or business expenses).

(c) *Cross references.* Certain items of a personal, living, or family nature are deductible to the extent expressly provided under the following sections, and the regulations under those sections:

(1) Section 163 (interest).

(2) Section 164 (taxes).

(3) Section 165 (losses).

(4) Section 166 (bad debts).

(5) Section 170 (charitable, etc., contributions and gifts).

(6) Section 213 (medical, dental, etc., expenses).

(7) Section 214 (expenses for care of certain dependents).

(8) Section 215 (alimony, etc., payments).

(9) Section 216 (amounts representing taxes and interest paid to cooperative housing corporation).

(10) Section 217 (moving expenses).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6796, 30 FR 1041, Feb. 2, 1965; T.D. 6918, 32 FR 6681, May 2, 1967; T.D. 7207, 37 FR 20795, Oct. 4, 1972; T.D. 9696, 79 FR 59114, Oct. 1, 2014]

§ 1.263(a)–0 Outline of regulations under section 263(a).

This section lists the paragraphs in §§ 1.263(a)–1 through 1.263(a)–3 and § 1.263(a)–6.

§ 1.263(a)–1 Capital expenditures; in general.

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§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

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(3) Real property.
(4) Produce.
(c) Coordination with other provisions of the Internal Revenue Code.
(1) In general.
(2) Materials and supplies.
(d) Acquired or produced tangible property.
(1) Requirement to capitalize.
(2) Examples.
(e) Defense or perfection of title to property.
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(2) Scope of facilitate.
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§ 1.263(a)–1 Capital expenditures; in general.

(a) *General rule for capital expenditures.* Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for—

(1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or

(2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

(b) *Coordination with other provisions of the Internal Revenue Code.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code or the Treasury Regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A, which requires taxpayers to capitalize the direct and allocable indirect costs to property produced by the taxpayer and property acquired for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(c) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and § 1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph

(c)(2) and are separately defined and addressed in § 1.263(a)–3.

(d) *Examples of capital expenditures.* The following amounts paid are examples of capital expenditures:

(1) An amount paid to acquire or produce a unit of real or personal tangible property. See § 1.263(a)–2.

(2) An amount paid to improve a unit of real or personal tangible property. See § 1.263(a)–3.

(3) An amount paid to acquire or create intangibles. See § 1.263(a)–4.

(4) An amount paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure of a business entity, and certain other transactions. See § 1.263(a)–5.

(5) An amount paid to acquire or create interests in land, such as easements, life estates, mineral interests, timber rights, zoning variances, or other interests in land.

(6) An amount assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. See section 118 and § 1.118–1.

(7) An amount paid by a holding company to carry out a guaranty of dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary. This amount must be added to the cost of the stock in the subsidiary.

(e) *Amounts paid to sell property*—(1) *In general.* Commissions and other transaction costs paid to facilitate the sale of property are not currently deductible under section 162 or 212. Instead, the amounts are capitalized costs that reduce the amount realized in the taxable year in which the sale occurs or are taken into account in the taxable year in which the sale is abandoned if a deduction is permissible. These amounts are not added to the basis of the property sold or treated as an intangible asset under § 1.263(a)–4. See § 1.263(a)–5(g) for the treatment of amounts paid to facilitate the disposition of assets that constitute a trade or business.

(2) *Dealer in property.* In the case of a dealer in property, amounts paid to facilitate the sale of such property are treated as ordinary and necessary business expenses.

(3) *Examples.* The following examples, which assume the sale is not an installment sale under section 453, illustrate the rules of this paragraph (e):

Example 1. Sales costs of real property A owns a parcel of real estate. A sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. A must capitalize the fees and commissions and, in the taxable year of the sale, must reduce the amount realized from the sale of the real estate by the fees and commissions.

Example 2. Sales costs of dealers Assume the same facts as in *Example 1,* except that A is a dealer in real estate. The commissions and fees paid to facilitate the sale of the real estate may be deducted as ordinary and necessary business expenses under section 162.

Example 3. Sales costs of personal property used in a trade or business B owns a truck for use in B's trade or business. B decides to sell the truck on November 15, Year 1. B pays for an appraisal to determine a reasonable asking price. On February 15, Year 2, B sells the truck to C. In Year 1, B must capitalize the amount paid to appraise the truck, and in Year 2, must reduce the amount realized from the sale of the truck by the amount paid for the appraisal.

Example 4. Costs of abandoned sale of personal property used in a trade or business Assume the same facts as in *Example 3,* except that, instead of selling the truck on February 15, Year 2, B decides on that date not to sell the truck and takes the truck off the market. In Year 1, B must capitalize the amount paid to appraise the truck. However, B may recognize the amount paid to appraise the truck as a loss under section 165 in Year 2, the taxable year when the sale is abandoned.

Example 5. Sales costs of personal property not used in a trade or business Assume the same facts as in *Example 3,* except that B does not use the truck in B's trade or business but instead uses it for personal purposes. In Year 1, B must capitalize the amount paid to appraise the truck, and in Year 2, must reduce the amount realized from the sale of the truck by the amount paid for the appraisal.

Example 6. Costs of abandoned sale of personal property not used in a trade or business Assume the same facts as in *Example 5,* except that, instead of selling the truck on February 15, Year 2, B decides on that date not to sell the truck and takes the truck off the market. In Year 1, B must capitalize the amount paid to appraise the truck. Although B abandons the sale in Year 2, B may not treat the amount paid to appraise the truck as a loss under section 165 because the truck was not used in B's trade or business or in a transaction entered into for profit.

(f) *De minimis safe harbor election*—(1) *In general.* Except as otherwise provided in paragraph (f)(2) of this section, a taxpayer electing to apply the de minimis safe harbor under this paragraph (f) may not capitalize under §1.263(a)–2(d)(1) or §1.263(a)–3(d) any amount paid in the taxable year for the acquisition or production of a unit of tangible property nor treat as a material or supply under §1.162–3(a) any amount paid in the taxable year for tangible property if the amount specified under this paragraph (f)(1) meets the requirements of paragraph (f)(1)(i) or (f)(1)(ii) of this section. However, section 263A and the regulations under section 263A require taxpayers to capitalize the direct and allocable indirect costs of property produced by the taxpayer (for example, property improved by the taxpayer) and property acquired for resale.

(i) *Taxpayer with applicable financial statement.* A taxpayer electing to apply the de minimis safe harbor may not capitalize under §1.263(a)–2(d)(1) or §1.263(a)–3(d) nor treat as a material or supply under §1.162–3(a) any amount paid in the taxable year for property described in paragraph (f)(1) of this section if—

(A) The taxpayer has an applicable financial statement (as defined in paragraph (f)(4) of this section);

(B) The taxpayer has at the beginning of the taxable year written accounting procedures treating as an expense for non-tax purposes—

(*1*) Amounts paid for property costing less than a specified dollar amount; or

(*2*) Amounts paid for property with an economic useful life (as defined in §1.162–3(c)(4)) of 12 months or less;

(C) The taxpayer treats the amount paid for the property as an expense on its applicable financial statement in accordance with its written accounting procedures; and

(D) The amount paid for the property does not exceed $5,000 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Taxpayer without applicable financial statement.* A taxpayer electing to apply the de minimis safe harbor may not capitalize under §1.263(a)–2(d)(1) or §1.263(a)–3(d) nor treat as a material or supply under §1.162–3(a) any amount paid in the taxable year for property described in paragraph (f)(1) of this section if—

(A) The taxpayer does not have an applicable financial statement (as defined in paragraph (f)(4) of this section);

(B) The taxpayer has at the beginning of the taxable year accounting procedures treating as an expense for non-tax purposes—

(*1*) Amounts paid for property costing less than a specified dollar amount; or

(*2*) Amounts paid for property with an economic useful life (as defined in §1.162–3(c)(4)) of 12 months or less;

(C) The taxpayer treats the amount paid for the property as an expense on its books and records in accordance with these accounting procedures; and

(D) The amount paid for the property does not exceed $500 per invoice (or per item as substantiated by the invoice) or other amount as identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Taxpayer with both an applicable financial statement and a non-qualifying financial statement.* For purposes of this paragraph (f)(1), if a taxpayer has an applicable financial statement defined in paragraph (f)(4) of this section in addition to a financial statement that does not meet requirements of paragraph (f)(4) of this section, the taxpayer must meet the requirements of paragraph (f)(1)(i) of this section to qualify to elect the de minimis safe harbor under this paragraph (f).

(2) *Exceptions to de minimis safe harbor.* The de minimis safe harbor in paragraph (f)(1) of this section does not apply to the following:

(i) Amounts paid for property that is or is intended to be included in inventory property;

(ii) Amounts paid for land;

(iii) Amounts paid for rotable, temporary, and standby emergency spare parts that the taxpayer elects to capitalize and depreciate under § 1.162–3(d); and

(iv) Amounts paid for rotable and temporary spare parts that the taxpayer accounts for under the optional method of accounting for rotable parts pursuant to § 1.162–3(e).

(3) *Additional rules*—(i) *Transaction and other additional costs.* A taxpayer electing to apply the de minimis safe harbor under paragraph (f)(1) of this section is not required to include in the cost of the tangible property the additional costs of acquiring or producing such property if these costs are not included in the same invoice as the tangible property. However, the taxpayer electing to apply the de minimis safe harbor under paragraph (f)(1) of this section must include in the cost of such property all additional costs (for example, delivery fees, installation services, or similar costs) if these additional costs are included on the same invoice with the tangible property. For purposes of this paragraph, if the invoice includes amounts paid for multiple tangible properties and such invoice includes additional invoice costs related to these multiple properties, then the taxpayer must allocate the additional invoice costs to each property using a reasonable method, and each property, including allocable labor and overhead, must meet the requirements of paragraph (f)(1)(i) or paragraph (f)(1)(ii) of this section, whichever is applicable. Reasonable allocation methods include, but are not limited to specific identification, a pro rata allocation, or a weighted average method based on the property's relative cost. For purposes of this paragraph (f)(3)(i), additional costs consist of the costs of facilitating the acquisition or production of such tangible property under § 1.263(a)–2(f) and the costs for work performed prior to the date that the tangible property is placed in service under § 1.263(a)–2(d).

(ii) *Materials and supplies.* If a taxpayer elects to apply the de minimis safe harbor provided under this paragraph (f), then the taxpayer must also apply the de minimis safe harbor to amounts paid for all materials and supplies (as defined under § 1.162–3) that meet the requirements of § 1.263(a)–1(f). See paragraph (f)(3)(iv) of this section for treatment of materials and supplies under the de minimis safe harbor.

(iii) *Sale or disposition.* Property to which a taxpayer applies the de minimis safe harbor contained in this paragraph (f) is not treated upon sale or other disposition as a capital asset under section 1221 or as property used in the trade or business under section 1231.

(iv) *Treatment of de minimis amounts.* An amount paid for property to which a taxpayer properly applies the de minimis safe harbor contained in this paragraph (f) is not treated as a capital expenditure under § 1.263(a)–2(d)(1) or § 1.263(a)–3(d) or as a material and supply under § 1.162–3, and may be deducted under § 1.162–1 in the taxable year the amount is paid provided the amount otherwise constitutes an ordinary and necessary expense incurred in carrying on a trade or business.

(v) *Coordination with section 263A.* Amounts paid for tangible property described in paragraph (f)(1) of this section may be subject to capitalization under section 263A if the amounts paid for tangible property comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale. See, for example, § 1.263A–1(e)(3)(ii)(R) requiring taxpayers to capitalize the cost of tools and equipment allocable to property produced or property acquired for resale.

(vi) *Written accounting procedures for groups of entities.* If the taxpayer's financial results are reported on the applicable financial statement (as defined in paragraph (f)(4) of this section) for a group of entities then, for purposes of paragraph (f)(1)(i)(A) of this section, the group's applicable financial statement may be treated as the applicable financial statement of the taxpayer, and for purposes of paragraphs (f)(1)(i)(B) and (f)(1)(i)(C) of this section, the written accounting procedures provided for the group and utilized for the group's applicable financial statement may be treated as the written accounting procedures of the taxpayer.

(vii) *Combined expensing accounting procedures.* For purposes of paragraphs (f)(1)(i) and (f)(1)(ii) of this section, if the taxpayer has, at the beginning of the taxable year, accounting procedures treating as an expense for non-tax purposes amounts paid for property costing less than a specified dollar amount and amounts paid for property with an economic useful life (as defined in §1.162–3(c)(4)) of 12 months or less, then a taxpayer electing to apply the de minimis safe harbor under this paragraph (f) must apply the provisions of this paragraph (f) to amounts qualifying under either accounting procedure.

(4) *Definition of applicable financial statement.* For purposes of this paragraph (f), the taxpayer's applicable financial statement (AFS) is the taxpayer's financial statement listed in paragraphs (f)(4)(i) through (iii) of this section that has the highest priority (including within paragraph (f)(4)(ii) of this section). The financial statements are, in descending priority—

(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10–K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for—

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose; or

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

(5) *Time and manner of election.* A taxpayer that makes the election under this paragraph (f) must make the election for all amounts paid during the taxable year for property described in paragraph (f)(1) of this section and meeting the requirements of paragraph (f)(1)(i) or paragraph (f)(1)(ii) of this section, as applicable. A taxpayer makes the election by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which these amounts are paid. Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled "Section 1.263(a)–1(f) de minimis safe harbor election" and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the de minimis safe harbor election under §1.263(a)–1(f). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (f). The manner of electing the de minimis safe harbor under this paragraph (f) may be modified through guidance of general applicability (see §§601.601(d)(2) and 601.602 of this chapter).

(6) *Anti-abuse rule.* If a taxpayer acts to manipulate transactions with the intent to achieve a tax benefit or to avoid the application of the limitations provided under paragraphs (f)(1)(i)(B)(*1*), (f)(1)(i)(D), (f)(1)(ii)(B)(*1*), and (f)(1)(ii)(D) of this section, appropriate adjustments will be made to carry out the purposes of this section. For example, a taxpayer is deemed to act to manipulate transactions with an intent to avoid the purposes and requirements of this section if—

(i) The taxpayer applies the de minimis safe harbor to amounts substantiated with invoices created to componentize property that is generally acquired or produced by the taxpayer (or other taxpayers in the same or similar trade or business) as a single unit of tangible property; and

(ii) This property, if treated as a single unit, would exceed any of the limitations provided under paragraphs (f)(1)(i)(B)(*1*), (f)(1)(i)(D), (f)(1)(ii)(B)(*1*), and (f)(1)(ii)(D) of this section, as applicable.

(7) *Examples.* The following examples illustrate the application of this paragraph (f). Unless otherwise provided, assume that section 263A does not apply to the amounts described.

Example 1. De minimis safe harbor; taxpayer without AFS. In Year 1, A purchases 10 printers at $250 each for a total cost of $2,500 as indicated by the invoice. Assume that each printer is a unit of property under §1.263(a)–3(e). A does not have an AFS. A has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500, and A treats the amounts paid for the printers as an expense on its books and records. The amounts paid for the printers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If A elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, A may not capitalize the amounts paid for the 10 printers or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1). Instead, in accordance with paragraph (f)(3)(iv) of this section, A may deduct these amounts under §1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 2. De minimis safe harbor; taxpayer without AFS. In Year 1, B purchases 10 computers at $600 each for a total cost of $6,000 as indicated by the invoice. Assume that each computer is a unit of property under §1.263(a)–3(e). B does not have an AFS. B has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $1,000 and B treats the amounts paid for the computers as an expense on its books and records. The amounts paid for the printers do not meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section because the amount paid for the property exceeds $500 per invoice (or per item as substantiated by the invoice). B may not apply the de minimis safe harbor election to the amounts paid for the 10 computers under paragraph (f)(1) of this section.

Example 3. De minimis safe harbor; taxpayer with AFS. C is a member of a consolidated group for Federal income tax purposes. C's financial results are reported on the consolidated applicable financial statements for the affiliated group. C's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by C, to expense amounts paid for property costing $5,000 or less. In Year 1, C pays $6,250,000 to purchase 1,250 computers at $5,000 each. C receives an invoice from its supplier indicating the total amount due ($6,250,000) and the price per item ($5,000). Assume that each computer is a unit of property under §1.263(a)–3(e). The amounts paid for the computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If C elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, C may not capitalize the amounts paid for the 1,250 computers or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, C may deduct these amounts under §1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 4. De minimis safe harbor; taxpayer with AFS. D is a member of a consolidated group for Federal income tax purposes. D's financial results are reported on the consolidated applicable financial statements for the affiliated group. D's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by D, to expense amounts paid for property costing less than $15,000. In Year 1, D pays $4,800,000 to purchase 800 elliptical machines at $6,000 each. D receives an invoice from its supplier indicating the total amount due ($4,800,000) and the price per item ($6,000). Assume that each elliptical machine is a unit of property under §1.263(a)–3(e). D may not apply the de minimis safe harbor election to the amounts paid for the 800 elliptical machines under paragraph (f)(1) of this section because the amount paid for the property exceeds $5,000 per invoice (or per item as substantiated by the invoice).

Example 5. De minimis safe harbor; additional invoice costs. E is a member of a consolidated group for Federal income tax purposes. E's financial results are reported on the consolidated applicable financial statements for the affiliated group. E's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by E, to expense amounts paid for property costing less than $5,000. In Year 1, E pays $45,000 for the purchase and installation of wireless routers in each of its 10 office locations. Assume that each wireless router is a unit of property under §1.263(a)–3(e). E receives an invoice from its supplier indicating the total amount due ($45,000), including the material price per item ($2,500), and total delivery and installation ($20,000). E allocates the additional invoice costs to the materials on a pro rata basis, bringing the cost of each router to $4,500 ($2,500 materials + $2,000 labor and overhead). The amounts paid for each router, including the allocable additional invoice costs, meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If E elects to apply the de minimis safe harbor under this paragraph (f) for Year 1, E may not capitalize the amounts paid for the 10 routers (including the additional invoice costs) or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, E may deduct these amounts under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 6. De minimis safe harbor; non-invoice additional costs. F is a corporation that provides consulting services to its customer. F does not have an AFS, but F has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500. In Year 1, F pays $600 to an interior designer to shop for, evaluate, and make recommendations regarding purchasing new furniture for F's conference room. As a result of the interior designer's recommendations, F acquires a conference table for $500 and 10 chairs for $300 each. In Year 1, F receives an invoice from the interior designer for $600 for his services, and F receives a separate invoice from the furniture supplier indicating a total amount due of $500 for the table and $300 for each chair. For Year 1, F treats the amount paid for the table and each chair as an expense on its books and records, and F elects to use the de minimis safe harbor for amounts paid for tangible property that qualify under the safe harbor. The amount paid to the interior designer is a cost of facilitating the acquisition of the table and chairs under § 1.263(a)–2(f). Under paragraph (f)(3)(i) of this section, F is not required to include in the cost of tangible property the additional costs of acquiring such property if these costs are not included in the same invoice as the tangible property. Thus, F is not required to include a pro rata allocation of the amount paid to the interior designer to determine the application of the de minimis safe harbor to the table and the chairs. Accordingly, the amounts paid by F for the table and each chair meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section, and F may not capitalize the amounts paid for the table or each chair under paragraph (f)(1) of this section. In addition, F is not required to capitalize the amounts paid to the interior designer as a cost that facilitates the acquisition of tangible property under § 1.263(a)–2(f)(3)(i). Instead, F may deduct the amounts paid for the table, chairs, and interior designer under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 7. De minimis safe harbor; 12-month economic useful life. G operates a restaurant. In Year 1, G purchases 10 hand-held point-of-service devices at $300 each for a total cost of $3,000 as indicated by invoice. G also purchases 3 tablet computers at $500 each for a total cost of $1,500 as indicated by invoice. Assume each point-of-service device and each tablet computer has an economic useful life of 12 months or less, beginning when they are used in G's business. Assume that each device and each tablet is a unit of property under § 1.263(a)–3(e). G does not have an AFS, but G has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing $300 or less and to expense amounts paid for property with an economic useful life of 12 months or less. Thus, G expenses the amounts paid for the hand-held devices on its books and records because each device costs $300. G also expenses the amounts paid for the tablet computers on its books and records because the computers have an economic useful life of 12 months of less, beginning when they are used. The amounts paid for the hand-held devices and the tablet computers meet the requirements for the de minimis safe harbor under paragraph (f)(1)(ii) of this section. If G elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, G may not capitalize the amounts paid for the hand-held devices, the tablet computers, or any other amounts meeting the criteria for the de minimis safe harbor under paragraph (f)(1) of this section. Instead, in accordance with paragraph (f)(3)(iv) of this section, G may deduct the amounts paid for the hand-held devices and tablet computers under § 1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary business expenses incurred in carrying on a trade or business.

Example 8. De minimis safe harbor; limitation. Assume the facts as in *Example 7*, except G purchases the 3 tablet computers at $600 each for a total cost of $1,800. The amounts paid for the tablet computers do not meet the de minimis rule safe harbor under paragraphs (f)(1)(ii) and (f)(3)(vii) of this section because the cost of each computer exceeds $500. Therefore, the amounts paid for the tablet computers may not be deducted under the safe harbor.

Example 9. De minimis safe harbor; materials and supplies. H is a corporation that provides consulting services to its customers. H has an AFS and a written accounting policy at the beginning of the taxable year to expense amounts paid for property costing $5,000 or less. In Year 1, H purchases 1,000 computers at $500 each for a total cost of $500,000. Assume that each computer is a unit of property under §1.263(a)–3(e) and is not a material or supply under §1.162–3. In addition, H purchases 200 office chairs at $100 each for a total cost of $20,000 and 250 customized briefcases at $80 each for a total cost of $20,000. Assume that each office chair and each briefcase is a material or supply under §1.162–3(c)(1). H treats the amounts paid for the computers, office chairs, and briefcases as expenses on its AFS. The amounts paid for computers, office chairs, and briefcases meet the requirements for the de minimis safe harbor under paragraph (f)(1)(i) of this section. If H elects to apply the de minimis safe harbor under this paragraph (f) in Year 1, H may not capitalize the amounts paid for the 1,000 computers, the 200 office chairs, and the 250 briefcases under paragraph (f)(1) of this section. H may deduct the amounts paid for the computers, the office chairs, and the briefcases under §1.162–1 in the taxable year the amounts are paid provided the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business.

Example 10. De minimis safe harbor; coordination with section 263A. J is a member of a consolidated group for Federal income tax purposes. J's financial results are reported on the consolidated AFS for the affiliated group. J's affiliated group has a written accounting policy at the beginning of Year 1, which is followed by J, to expense amounts paid for property costing less than $1,000 or that has an economic useful life of 12 months or less. In Year 1, J acquires jigs, dies, molds, and patterns for use in the manufacture of J's products. Assume each jig, die, mold, and pattern is a unit of property under §1.263(a)–3(e) and costs less than $1,000. In Year 1, J begins using the jigs, dies, molds and patterns to manufacture its products. Assume these items are materials and supplies under §1.162–3(c)(1)(iii), and J elects to apply the de minimis safe harbor under paragraph (f)(1)(i) of this section to amounts qualifying under the safe harbor in Year 1. Under paragraph (f)(3)(v) of this section, the amounts paid for the jigs, dies, molds, and patterns may be subject to capitalization under section 263A if the amounts paid for these tangible properties comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale.

Example 11. De minimis safe harbor; anti-abuse rule. K is a corporation that provides hauling services to its customers. In Year 1, K decides to purchase a truck to use in its business. K does not have an AFS. K has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than $500. K arranges to purchase a used truck for a total of $1,500. Prior to the acquisition, K requests the seller to provide multiple invoices for different parts of the truck. Accordingly, the seller provides K with four invoices during Year 1—one invoice of $500 for the cab, one invoice of $500 for the engine, one invoice of $300 for the trailer, and a fourth invoice of $200 for the tires. K treats the amounts paid under each invoice as an expense on its books and records. K elects to apply the de minimis safe harbor under paragraph (f) of this section in Year 1 and does not capitalize the amounts paid for each invoice pursuant to the safe harbor. Under paragraph (f)(6) of this section, K has applied the de minimis rule to amounts substantiated with invoices created to componentize property that is generally acquired as a single unit of tangible property in the taxpayer's type of business, and this property, if treated as single unit, would exceed the limitations provided under the de minimis rule. Accordingly, K is deemed to manipulate the transaction to acquire the truck with the intent to avoid the purposes of this paragraph (f). As a result, K may not apply the de minimis rule to these amounts and is subject to appropriate adjustments.

(g) *Accounting method changes.* Except for paragraph (f) of this section (the de minimis safe harbor election), a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(h) *Effective/applicability date*—(1) *In general.* Except for paragraph (f) of this section, this section generally applies to taxable years beginning on or after January 1, 2014. Paragraph (f) of this section applies to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraph (h)(1) and paragraph (h)(2) of this section, §1.263(a)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraph (f) of this section, a taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012. A

taxpayer may choose to apply paragraph (f) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for de minimis safe harbor election on 2012 or 2013 returns.* If under paragraph (h)(2)(i) of this section, a taxpayer chooses to make the election to apply the de minimis safe harbor under paragraph (f) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (f)(5) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (f)(5) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply §1.263(a)–1T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57710, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014]

§ 1.263(a)–2 Amounts paid to acquire or produce tangible property.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property. Paragraph (b) of this section contains definitions. Paragraph (c) of this section contains the rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the general requirement to capitalize amounts paid to acquire or produce a unit of real or personal property. Paragraph (e) of this section provides the requirement to capitalize amounts paid to defend or perfect title to real or personal property. Paragraph (f) of this section provides the rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of tangible property. Paragraphs (g) and (h) of this section address the treatment and recovery of capital expenditures. Paragraph (i) of this section provides for changes in methods of accounting to comply with this section, and paragraph (j) of this section provides the effective and applicability dates for the rules under this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Personal property* means tangible personal property as defined in §1.48–1(c).

(3) *Real property* means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under §1.48–1(d) is treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) *Produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and §1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (b)(4) and are separately defined and addressed in §1.263(a)–3.

(c) *Coordination with other provisions of the Code*—(1) *In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Code or the Treasury Regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale. See also section 195 requiring taxpayers to capitalize certain costs as start-up expenditures.

(2) *Materials and supplies.* Nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under § 1.162–3.

(d) *Acquired or produced tangible property*—(1) *Requirement to capitalize.* Except as provided in § 1.162–3 (relating to materials and supplies) and in § 1.263(a)–1(f) (providing a de minimis safe harbor election), a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property (as determined under § 1.263(a)–3(e)), including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Section 1.263(a)–3(f) provides the rules for determining whether amounts are for leasehold improvements. Amounts paid to acquire or produce a unit of real or personal property include the invoice price, transaction costs as determined under paragraph (f) of this section, and costs for work performed prior to the date that the unit of property is placed in service by the taxpayer (without regard to any applicable convention under section 168(d)). A taxpayer also must capitalize amounts paid to acquire real or personal property for resale.

(2) *Examples.* The following examples illustrate the rules of this paragraph (d). Unless otherwise provided, assume that the taxpayer does not elect the de minimis safe harbor under § 1.263(a)–1(f) and that the property is not acquired for resale under section 263A.

Example 1. Acquisition of personal property. A purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume each cash register is a unit of property as determined under § 1.263(a)–3(e) and is not a material or supply under § 1.162–3. A must capitalize under paragraph (d)(1) of this section the amount paid to acquire each cash register.

Example 2. Acquisition of personal property that is a material or supply; coordination with § 1.162–3. B operates a fleet of aircraft. In Year 1, B acquires a stock of component parts, which it intends to use to maintain and repair its aircraft. Assume that each component part is a material or supply under § 1.162–3(c)(1) and B does not make elections under § 1.162–3(d) to treat the materials and supplies as capital expenditures. In Year 2, B uses the component parts in the repair and maintenance of its aircraft. Because the parts are materials and supplies under § 1.162–3, B is not required to capitalize the amounts paid for the parts under paragraph (d)(1) of this section. Rather, to determine the treatment of these amounts, B must apply the rules under § 1.162–3, governing the treatment of materials and supplies.

Example 3. Acquisition of unit of personal property; coordination with § 1.162–3. C operates a rental business that rents out a variety of small individual items to customers (rental items). C maintains a supply of rental items on hand to replace worn or damaged items. C purchases a large quantity of rental items to be used in its business. Assume that each of these rental items is a unit of property under § 1.263(a)–3(e). Also assume that a portion of the rental items are materials and supplies under § 1.162–3(c)(1). Under paragraph (d)(1) of this section, C must capitalize the amounts paid for the rental items that are not materials and supplies under § 1.162–3(c)(1). However, C must apply the rules in § 1.162–3 to determine the treatment of the rental items that are materials and supplies under § 1.162–3(c)(1).

Example 4. Acquisition or production cost. D purchases and produces jigs, dies, molds, and patterns for use in the manufacture of D's products. Assume that each of these items is a unit of property as determined under § 1.263(a)–3(e) and is not a material and supply under § 1.162–3(c)(1). D is required to capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the jigs, dies, molds, and patterns.

Example 5. Acquisition of land. F purchases a parcel of undeveloped real estate. F must capitalize under paragraph (d)(1) of this section the amount paid to acquire the real estate. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 6. Acquisition of building. G purchases a building. G must capitalize under paragraph (d)(1) of this section the amount paid to acquire the building. See paragraph (f) of this section for the treatment of amounts paid to facilitate the acquisition of real property.

Example 7. Acquisition of property for resale and production of property for sale; coordination with section 263A. H purchases goods for resale and produces other goods for sale. H must capitalize under paragraph (d)(1) of this section the amounts paid to acquire and produce the goods. See section 263A for the amounts required to be capitalized to the property produced or to the property acquired for resale.

Example 8. Production of building; coordination with section 263A. J constructs a building. J must capitalize under paragraph (d)(1) of this section the amount paid to construct the building. See section 263A for the costs required to be capitalized to the real property produced by J.

Example 9. Acquisition of assets constituting a trade or business. K owns tangible and intangible assets that constitute a trade or business. L purchases all the assets of K in a taxable transaction. L must capitalize under paragraph (d)(1) of this section the amount paid for the tangible assets of K. See §1.263(a)–4 for the treatment of amounts paid to acquire or create intangibles and §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See section 1060 for special allocation rules for certain asset acquisitions.

Example 10. Work performed prior to placing the property in service. In Year 1, M purchases a building for use as a business office. Prior to placing the building in service, M pays amounts to repair cement steps, refinish wood floors, patch holes in walls, and paint the interiors and exteriors of the building. In Year 2, M places the building in service and begins using the building as its business office. Assume that the work that M performs does not constitute an improvement to the building or its structural components under §1.263(a)–3. Under §1.263–3(e)(2)(i), the building and its structural components is a single unit of property. Under paragraph (d)(1) of this section, the amounts paid must be capitalized as amounts to acquire the building unit of property because they were for work performed prior to M's placing the building in service.

Example 11. Work performed prior to placing the property in service. In January Year 1, N purchases a new machine for use in an existing production line of its manufacturing business. Assume that the machine is a unit of property under §1.263(a)–3(e) and is not a material or supply under §1.162–3. N pays amounts to install the machine, and after the machine is installed, N pays amounts to perform a critical test on the machine to ensure that it will operate in accordance with quality standards. On November 1, Year 1, the critical test is complete, and N places the machine in service on the production line. N pays amounts to perform periodic quality control testing after the machine is placed in service. Under paragraph (d)(1) of this section, the amounts paid for the installation and the critical test performed before the machine is placed in service must be capitalized by N as amounts to acquire the machine. However, amounts paid for periodic quality control testing after N placed the machine in service are not required to be capitalized as amounts paid to acquire the machine.

(e) *Defense or perfection of title to property*—(1) *In general.* Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized.

(2) *Examples.* The following examples illustrate the rule of this paragraph (e):

Example 1. Amounts paid to contest condemnation X owns real property located in County. County files an eminent domain complaint condemning a portion of X's property to use as a roadway. X hires an attorney to contest the condemnation. The amounts that X paid to the attorney must be capitalized because they were to defend X's title to the property.

Example 2. Amounts paid to invalidate ordinance. Y is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after Y establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of Y's business. Y incurs attorney's fees in a successful prosecution of a suit to invalidate the municipal ordinance. Y prosecutes the suit to preserve its business activities and not to defend Y's title in the property. Therefore, the attorney's fees that Y paid are not required to be capitalized under paragraph (e)(1) of this section.

Example 3. Amounts paid to challenge building line. The board of public works of a municipality establishes a building line across Z's business property, adversely affecting the value of the property. Z incurs legal fees in unsuccessfully litigating the establishment of the building line. The amounts Z paid to the attorney must be capitalized because they were to defend Z's title to the property.

(f) *Transaction costs*—(1) *In general.* Except as provided in §1.263(a)–1(f)(3)(i) (for purposes of the de minimis safe harbor), a taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property. See §1.263(a)–5 for the treatment of amounts paid to facilitate the acquisition of assets that constitute a trade or business. See §1.167(a)–5 for allocations of facilitative costs between depreciable and non-depreciable property.

(2) *Scope of facilitate*—(i) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise

pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

(ii) *Inherently facilitative amounts.* An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for—

(A) Transporting the property (for example, shipping fees and moving costs);

(B) Securing an appraisal or determining the value or price of property;

(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

(D) Application fees, bidding costs, or similar expenses;

(E) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);

(F) Examining and evaluating the title of property;

(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;

(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs;

(I) Finders' fees or brokers' commissions, including contingency fees (defined in paragraph (f)(3)(iii) of this section);

(J) Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or

(K) Services provided by a qualified intermediary or other facilitator of an exchange under section 1031.

(iii) *Special rule for acquisitions of real property*—(A) *In general.* Except as provided in paragraph (f)(2)(ii) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire.

(B) *Acquisitions of real and personal property in a single transaction.* An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of personal property facilitates the acquisition of such personal property, even if such property is acquired in a single transaction that also includes the acquisition of real property subject to the special rule set out in paragraph (f)(2)(iii)(A) of this section. A taxpayer may use a reasonable allocation method to determine which costs facilitate the acquisition of personal property and which costs relate to the acquisition of real property and are subject to the special rule of paragraph (f)(2)(iii)(A) of this section.

(iv) *Employee compensation and overhead costs*—(A) *In general.* For purposes of paragraph (f) of this section, amounts paid for employee compensation (within the meaning of §1.263(a)–4(e)(4)(ii)) and overhead are treated as amounts that do not facilitate the acquisition of real or personal property. However, section 263A provides rules for employee compensation and overhead costs required to be capitalized to property produced by the taxpayer or to property acquired for resale.

(B) *Election to capitalize.* A taxpayer may elect to treat amounts paid for employee compensation or overhead as amounts that facilitate the acquisition of property. The election is made separately for each acquisition and applies to employee compensation or overhead, or both. For example, a taxpayer may elect to treat overhead, but not employee compensation, as amounts that facilitate the acquisition of property. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the acquisition in the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year during which the amounts are paid. Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. A taxpayer may revoke an election made under this paragraph (f)(2)(iv)(B) with respect to each acquisition only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the interests of Government. See generally §301.9100–3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (f)(2)(iv)(B) may be modified through guidance of general applicability (see §§606.601(d)(2) and 601.602 of this section). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

(3) *Treatment of transaction costs*—(i) *In general*. Except as provided under §1.263(a)–1(f)(3)(i) (for purposes of the de minimis safe harbor), all amounts paid to facilitate the acquisition of real or personal property are capital expenditures. Facilitative amounts allocable to real or personal property must be included in the basis of the property acquired.

(ii) *Treatment of inherently facilitative amounts allocable to property not acquired*. Inherently facilitative amounts allocable to real or personal property are capital expenditures related to such property, even if the property is not eventually acquired. Except for contingency fees as defined in paragraph (f)(3)(iii) of this section, inherently facilitative amounts allocable to real or personal property not acquired may be allocated to those properties and recovered as appropriate in accordance with the applicable provisions of the Code and the Treasury Regulations (for example, sections 165, 167, or 168). See paragraph (h) of this section for the recovery of capitalized amounts.

(iii) *Contingency fees*. For purposes of this section, a contingency fee is an amount paid that is contingent on the successful closing of the acquisition of real or personal property. Contingency fees must be included in the basis of the property acquired and may not be allocated to the property not acquired.

(4) *Examples*. The following examples illustrate the rules of paragraph (f) of this section. For purposes of these examples, assume that the taxpayer does not elect the de minimis safe harbor under §1.263(a)–1(f):

Example 1. Broker's fees to facilitate an acquisition A decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. A pays fees to the broker to find property for A to acquire. Under paragraph (f)(2)(ii)(I) of this section, A must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

Example 2. Inspection and survey costs to facilitate an acquisition B decides to purchase Building X and pays amounts to third-party contractors for a termite inspection and an environmental survey of Building X. Under paragraph (f)(2)(ii)(J) of this section, B must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

Example 3. Moving costs to facilitate an acquisition C purchases all the assets of D and, in connection with the purchase, hires a transportation company to move storage tanks from D's plant to C's plant. Under paragraph (f)(2)(ii)(A) of this section, C must capitalize the amount paid to move the storage tanks from D's plant to C's plant because this cost is inherently facilitative to the acquisition of personal property.

Example 4. Geological and geophysical costs; coordination with other provisions E is in the business of exploring, purchasing, and developing properties in the United States for the production of oil and gas. E considers acquiring a particular property but first incurs costs for the services of an engineering firm to perform geological and geophysical studies to determine if the property is suitable for oil or gas production. Assume that the amounts that E paid to the engineering firm constitute geological and geophysical expenditures under section 167(h). Although the amounts that E paid for the geological and geophysical services are inherently facilitative to the acquisition of real property under paragraph (f)(2)(ii)(J) of this section, E is not required to include those amounts in the basis of the real property acquired. Rather, under paragraph (c) of this section, E must capitalize these costs separately and amortize such costs as required under section 167(h) (addressing the amortization of geological and geophysical expenditures).

Example 5. Scope of facilitate F is in the business of providing legal services to clients. F is interested in acquiring a new conference table for its office. F hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to F regarding which new table to acquire. Under paragraphs (f)(1) and (2) of this section, F must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

Example 6. Transaction costs allocable to multiple properties G, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. G considers various properties on Highway X in State Y. G incurs fees for the services of an architect to advise and evaluate the suitability of the sites for the type of facility that G intends to construct on the selected site. G must capitalize the architect fees as amounts paid to acquire land because these amounts are inherently facilitative to the acquisition of land under paragraph (f)(2)(ii)(J) of this section.

Example 7. Transaction costs; coordination with section 263A H, a retailer, wants to acquire land for the purpose of building a new distribution facility for its products. H considers various properties on Highway X in State Y. H incurs fees for the services of an architect to prepare preliminary floor plans for a building that H could construct at any of the sites. Under these facts, the architect's fees are not facilitative to the acquisition of land under paragraph (f) of this section. Therefore, H is not required to capitalize the architect fees as amounts paid to acquire land. However, the amounts paid for the architect's fees may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect cost of property produced by H, such as the building.

Example 8. Special rule for acquisitions of real property J owns several retail stores. J decides to examine the feasibility of opening a new store in City X. In October, Year 1, J hires and incurs costs for a development consulting firm to study City X and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that J should consider for purposes of locating a new store. In December, Year 1, J continues to consider whether to purchase real property in City X and which property to acquire. J hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site. In March, Year 2, J decides to acquire one of these two sites for the location of its new store. At the same time, J determines not to acquire the other site. Under paragraph (f)(2)(iii) of this section, J is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire, and the amounts are not inherently facilitative costs under paragraph (f)(2)(ii) of this section. However, J must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs under paragraph (f)(2)(ii)(B) of this section. In Year 2, J must include the appraisal costs allocable to property acquired in the basis of the property acquired. In addition, J may recover the appraisal costs allocable to the property not acquired in accordance with paragraphs (f)(3)(ii) and (h) of this section. See, for example, § 1.165–2 for losses on the permanent withdrawal of non-depreciable property.

Example 9. Contingency fee K owns several restaurant properties. K decides to open a new restaurant in City X. In October, Year 1, K hires a real estate consultant to identify potential property upon which K may locate its restaurant, and is obligated to compensate the consultant upon the acquisition of property. The real estate consultant identifies three properties, and K decides to acquire one of those properties. Upon closing of the acquisition of that property, K pays the consultant its fee. The amount paid to the consultant constitutes a contingency fee under paragraph (f)(3)(iii) of this section because the payment is contingent on the successful closing of the acquisition of property. Accordingly, under paragraph (f)(3)(iii) of this section, K must include the amount paid to the consultant in the basis of the property acquired. K is not permitted to allocate the amount paid between the properties acquired and not acquired.

Example 10. Employee compensation and overhead L, a freight carrier, maintains an acquisition department whose sole function is to arrange for the purchase of vehicles and aircraft from manufacturers or other parties to be used in its freight carrying business. As provided in paragraph (f)(2)(iv)(A) of this section, L is not required to capitalize any portion of the compensation paid to employees in its acquisition department or any portion of its overhead allocable to its acquisition department. However, under paragraph (f)(2)(iv)(B) of this section, L may elect to capitalize the compensation and/or overhead costs allocable to the acquisition of a vehicle or aircraft by treating these amounts as costs that facilitate the acquisition of that property in its timely filed original Federal tax return for the year the amounts are paid.

(g) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs.

(h) *Recovery of capitalized amounts*—(1) *In general.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable provisions of the Code and regulations relating to the use, sale, or disposition of property.

(2) *Examples.* The following examples illustrate the rule of paragraph (h)(1) of this section. For purposes of these examples, assume that the taxpayer does not elect the de minimis safe harbor under §1.263(a)–1(f).

Example 1. Recovery when property placed in service X owns a 10-unit apartment building. The refrigerator in one of the apartments stops functioning, and X purchases a new refrigerator to replace the old one. X pays for the acquisition, delivery, and installation of the new refrigerator. Assume that the refrigerator is the unit of property, as determined under §1.263(a)–3(e), and is not a material or supply under §1.162–3. Under paragraph (d)(1) of this section, X is required to capitalize the amounts paid for the acquisition, delivery, and installation of the refrigerator. Under this paragraph (h), the capitalized amounts are recovered through depreciation, which begins when the refrigerator is placed in service by X.

Example 2. Recovery when property used in the production of property Y operates a plant where it manufactures widgets. Y purchases a tractor loader to move raw materials into and around the plant for use in the manufacturing process. Assume that the tractor loader is a unit of property, as determined under §1.263(a)–3(e), and is not a material or supply under §1.162–3. Under paragraph (d)(1) of this section, Y is required to capitalize the amounts paid to acquire the tractor loader. Under this paragraph (h), the capitalized amounts are recovered through depreciation, which begins when Y places the tractor loader in service. However, because the tractor loader is used in the production of property, under section 263A the cost recovery (that is, the depreciation) may also be capitalized to Y's property produced, and, consequently, recovered through cost of goods sold. See §1.263A–1(e)(3)(ii)(I).

(i) *Accounting method changes.* Unless otherwise provided under this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(j) *Effective/applicability date*—(1) *In general.* Except for paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section, this section generally applies to taxable years beginning on or after January 1, 2014. Paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section apply to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(1) and (j)(2) of this section, §1.263(a)–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section of this section, a taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraphs (f)(2)(iii), (f)(2)(iv), and (f)(3)(ii) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for election to capitalize employee compensation and overhead costs on 2012 or 2013 returns.* If under paragraph (j)(2)(i) of this section, a taxpayer chooses to make the election to capitalize employee compensation and overhead costs under paragraph (f)(2)(iv)(B) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (f)(2)(iv)(B) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (f)(2)(iv)(B) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* Except for §1.263(a)–2T(f)(2)(iii), (f)(2)(iv), (f)(3)(ii), and (g), a taxpayer may choose to apply §1.263(a)–2T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014. A taxpayer may choose to apply §1.263(a)–2T(f)(2)(iii), (f)(2)(iv), (f)(3)(ii) and (g) as contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57714, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014]

§1.263(a)–3 Amounts paid to improve tangible property.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to improve tangible property. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules for coordinating this section with other provisions of the Internal Revenue Code (Code). Paragraph (d) of this section provides the requirement to capitalize amounts paid to improve tangible property and provides the general rules for determining whether a unit of property is improved. Paragraph (e) of this section provides the rules for determining the appropriate unit of property. Paragraph (f) of this section provides rules for leasehold improvements. Paragraph (g) of this section provides special rules for determining improvement costs in particular contexts, including indirect costs incurred during an improvement, removal costs, aggregation of related costs, and regulatory compliance costs. Paragraph (h) of this section provides a safe harbor for small taxpayers. Paragraph (i) provides a safe harbor for routine maintenance costs. Paragraph (j) of this section provides rules for determining whether amounts are paid for betterments to the unit of property. Paragraph (k) of this section provides rules for determining whether amounts are paid to restore the unit of property. Paragraph (l) of this section provides rules for amounts paid to adapt the unit of property to a new or different use. Paragraph (m) of this section provides an optional regulatory accounting method. Paragraph (n) of this section provides an election to capitalize repair and maintenance costs consistent with books and records. Paragraphs (o) and (p) of this section provide for the treatment and recovery of amounts capitalized under this section. Paragraphs (q) and (r) of this section provide for accounting method changes and state the effective/applicability date for the rules in this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Amount paid.* In the case of a taxpayer using an accrual method of accounting, the terms *amounts paid* and *payment* mean a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(2) *Personal property* means tangible personal property as defined in §1.48–1(c).

(3) *Real property* means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property as defined in paragraph (b)(2) of this section. Any property that constitutes other tangible property under §1.48–1(d) is also treated as real property for purposes of this section. Local law is not controlling in determining whether property is real property for purposes of this section.

(4) *Owner* means the taxpayer that has the benefits and burdens of ownership of the unit of property for Federal income tax purposes.

(c) *Coordination with other provisions of the Code*—(1) *In general.* Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Code or the regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see section 263A requiring taxpayers to capitalize the direct and allocable indirect costs of property produced and property acquired for resale.

(2) *Materials and supplies.* A material or supply as defined in §1.162–3(c)(1) that is acquired and used to improve a unit of tangible property is subject to this section and is not treated as a material or supply under §1.162–3.

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

Example. Railroad rolling stock X is a railroad that properly treats amounts paid for the rehabilitation of railroad rolling stock as deductible expenses under section 263(d). X is not required to capitalize the amounts paid because nothing in this section changes the treatment of amounts specifically provided for under section 263(d).

(d) *Requirement to capitalize amounts paid for improvements.* Except as provided in paragraph (h) or paragraph (n) of this section or under §1.263(a)–1(f), a taxpayer generally must capitalize the related amounts (as defined in paragraph (g)(3) of this section) paid to improve a unit of property owned by the taxpayer. However, paragraph (f) of this section applies to the treatment of amounts paid to improve leased property. Section 263A provides the requirement to capitalize the direct and allocable indirect costs of property produced by the taxpayer and property acquired for resale. Section 1016 provides for the addition of capitalized amounts to the basis of the property, and section 168 governs the treatment of additions or improvements for depreciation purposes. For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer—

(1) Are for a betterment to the unit of property (see paragraph (j) of this section);

(2) Restore the unit of property (see paragraph (k) of this section); or

(3) Adapt the unit of property to a new or different use (see paragraph (l) of this section).

(e) *Determining the unit of property*—(1) *In general.* The unit of property rules in this paragraph (e) apply only for purposes of section 263(a) and §§1.263(a)–1, 1.263(a)–2, 1.263(a)–3, and 1.162–3. Unless otherwise specified, the unit of property determination is based upon the functional interdependence standard provided in paragraph (e)(3)(i) of this section. However, special rules are provided for buildings (see paragraph (e)(2) of this section), plant property (see paragraph (e)(3)(ii) of this section), network assets (see paragraph (e)(3)(iii) of this section), leased property (see paragraph (e)(2)(v) of this section for leased buildings and paragraph (e)(3)(iv) of this section for leased property other than buildings), and improvements to property (see paragraph (e)(4) of this section). Additional rules are provided if a taxpayer has assigned different MACRS classes or depreciation methods to components of property or subsequently changes the class or depreciation method of a component or other item of property (see paragraph (e)(5) of this section). Property that is aggregated or subject to a general asset account election or accounted for in a multiple asset account (that is, pooled) may not be treated as a single unit of property.

(2) *Building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(4), and (e)(5)(ii) of this section, in the case of a building (as defined in §1.48–1(e)(1)), each building and its structural components (as defined in §1.48–1(e)(2)) is a single unit of property (''building''). Paragraph (e)(2)(iii) of this section provides the unit of property for condominiums, paragraph (e)(2)(iv) of this section provides the unit of property for cooperatives, and paragraph (e)(2)(v) of this section provides the unit of property for leased buildings.

(ii) *Application of improvement rules to a building.* An amount is paid to improve a building under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or paragraph (l) of this section to any of the following:

(A) *Building structure.* A building structure consists of the building (as defined in §1.48–1(e)(1)), and its structural components (as defined in §1.48–1(e)(2)), other than the structural components designated as buildings systems in paragraph (e)(2)(ii)(B) of this section.

(B) *Building system.* Each of the following structural components (as defined in §1.48–1(e)(2)), including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied—

(*1*) Heating, ventilation, and air conditioning (''HVAC'') systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

(*2*) Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

(*3*) Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from the property line to and between buildings and other permanent structures);

(*4*) All escalators;

(*5*) All elevators;

(*6*) Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and fire fighting equipment, such as extinguishers, and hoses);

(*7*) Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);

(*8*) Gas distribution system (including associated pipes and equipment used to distribute gas to and from the property line and between buildings or permanent structures); and

(*9*) Other structural components identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) that are excepted from the building structure under paragraph (e)(2)(ii)(A) of this section and are specifically designated as building systems under this section.

(iii) *Condominium*—(A) *In general.* In the case of a taxpayer that is the owner of an individual unit in a building with multiple units (such as a condominium), the unit of property (''condominium'') is the individual unit owned by the taxpayer and the structural components (as defined in §1.48–1(e)(2)) that are part of the unit.

(B) *Application of improvement rules to a condominium.* An amount is paid to improve a condominium under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or paragraph (l) of this section to the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) that is part of the condominium or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the condominium. In the case of the condominium management association, the association must apply the improvement rules to the building structure or to any building system described under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(iv) *Cooperative*—(A) *In general.* In the case of a taxpayer that has an ownership interest in a cooperative housing corporation, the unit of property (''cooperative'') is the portion of the building in which the taxpayer has possessory rights and the structural components (as defined in §1.48–1(e)(2)) that are part of the portion of the building subject to the taxpayer's possessory rights (cooperative).

(B) *Application of improvement rules to a cooperative.* An amount is paid to improve a cooperative under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or (l) of this section to the portion of the building structure (as defined in paragraph (e)(2)(ii)(A) of this section) in which the taxpayer has possessory rights or to the portion of any building system (as defined in paragraph (e)(2)(ii)(B) of this section) that is part of the portion of the building structure subject to the taxpayer's possessory rights. In the case of a cooperative housing corporation, the corporation must apply the improvement rules to the building structure or to any building system as described under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section.

(v) *Leased building*—(A) *In general.* In the case of a taxpayer that is a lessee of all or a portion of a building (such as an office, floor, or certain square footage), the unit of property (''leased building property'') is each building and its structural components or the portion of each building subject to the lease and the structural components associated with the leased portion.

(B) *Application of improvement rules to a leased building.* An amount is paid to improve a leased building property under paragraphs (d) and (f)(2) of this section if the amount is paid for an improvement, under paragraphs (j), (k), or (l) of this section, to any of the following:

(*1*) *Entire building.* In the case of a taxpayer that is a lessee of an entire building, the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) or any building system (as defined under paragraph (e)(2)(ii)(B) of this section) that is part of the leased building.

(*2*) *Portion of a building.* In the case of a taxpayer that is a lessee of a portion of a building (such as an office, floor, or certain square footage), the portion of the building structure (as defined under paragraph (e)(2)(ii)(A) of this section) subject to the lease or the portion of any building system (as defined under paragraph (e)(2)(ii)(B) of this section) subject to the lease.

(3) *Property other than building*—(i) *In general.* Except as otherwise provided in paragraphs (e)(3), (e)(4), (e)(5), and (f)(1) of this section, in the case of real or personal property other than property described in paragraph (e)(2) of this section, all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

(ii) *Plant property*—(A) *Definition.* For purposes of this paragraph (e), the term *plant property* means functionally interdependent machinery or equipment, other than network assets, used to perform an industrial process, such as manufacturing, generation, warehousing, distribution, automated materials handling in service industries, or other similar activities.

(B) *Unit of property for plant property.* In the case of plant property, the unit of property determined under the general rule of paragraph (e)(3)(i) of this section is further divided into smaller units comprised of each component (or group of components) that performs a discrete and major function or operation within the functionally interdependent machinery or equipment.

(iii) *Network assets*—(A) *Definition.* For purposes of this paragraph (e), the term *network assets* means railroad track, oil and gas pipelines, water and sewage pipelines, power transmission and distribution lines, and telephone and cable lines that are owned or leased by taxpayers in each of those respective industries. The term includes, for example, trunk and feeder lines, pole lines, and buried conduit. It does not include property that would be included as building structure or building systems under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section, nor does it include separate property that is adjacent to, but not part of a network asset, such as bridges, culverts, or tunnels.

(B) *Unit of property for network assets.* In the case of network assets, the unit of property is determined by the taxpayer's particular facts and circumstances except as otherwise provided in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter). For these purposes, the functional interdependence standard provided in paragraph (e)(3)(i) of this section is not determinative.

(iv) *Leased property other than buildings.* In the case of a taxpayer that is a lessee of real or personal property other than property described in paragraph (e)(2) of this section, the unit of property for the leased property is determined under paragraphs (e)(3)(i),(ii), (iii), and (e)(5) of this section except that, after applying the applicable rules under those paragraphs, the unit of property may not be larger than the property subject to the lease.

(4) *Improvements to property.* An improvement to a unit of property generally is not a unit of property separate from the unit of property improved. For the unit of property for lessee improvements, see also paragraph (f)(2)(ii)) of this section. If a taxpayer elects to treat as a capital expenditure under §1.162–3(d) the amount paid for a rotable spare part, temporary spare part, or standby emergency spare part, and such part is used in an improvement to a unit of property, then for purposes of applying paragraph (d) of this section to the unit of property improved, the part is not a unit of property separate from the unit of property improved.

(5) *Additional rules*—(i) *Year placed in service.* Notwithstanding the unit of property determination under paragraph (e)(3) of this section, a component (or a group of components) of a unit property must be treated as a separate unit of property if, at the time the unit of property is initially placed in service by the taxpayer, the taxpayer has properly treated the component as being within a different class of property under section 168(e) (MACRS classes) than the class of the unit of property of which the component is a part, or the taxpayer has properly depreciated the component using a different depreciation method than the depreciation method of the unit of property of which the component is a part.

(ii) *Change in subsequent taxable year.* Notwithstanding the unit of property determination under paragraphs (e)(2), (3), (4), or (5)(i) of this section, in any taxable year after the unit of property is initially placed in service by the taxpayer, if the taxpayer or the Internal Revenue Service changes the treatment of that property (or any portion thereof) to a proper MACRS class or a proper depreciation method (for example, as a result of a cost segregation study or a change in the use of the property), then the taxpayer must change the unit of property determination for that property (or the portion thereof) under this section to be consistent with the change in treatment for depreciation purposes. Thus, for example, if a portion of a unit of property is properly reclassified to a MACRS class different from the MACRS class of the unit of property of which it was previously treated as a part, then the reclassified portion of the property should be treated as a separate unit of property for purposes of this section.

(6) *Examples.* The following examples illustrate the application of this paragraph (e) and assume that the taxpayer has not made a general asset account election with regard to property or accounted for property in a multiple asset account. In addition, unless the facts specifically indicate otherwise, assume that the additional rules in paragraph (e)(5) of this section do not apply:

Example 1. Building systems A owns an office building that contains a HVAC system. The HVAC system incorporates ten roof-mounted units that service different parts of the building. The roof-mounted units are not connected and have separate controls and duct work that distribute the heated or cooled air to different spaces in the building's interior. A pays an amount for labor and materials for work performed on the roof-mounted units. Under paragraph (e)(2)(i) of this section, A must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(*1*) of this section, the entire HVAC system, including all of the roof-mounted units and their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by A for work on the roof-mounted units is an improvement (for example, a betterment) to the HVAC system, A must treat this amount as an improvement to the building.

Example 2. Building systems B owns a building that it uses in its retail business. The building contains two elevator banks in different locations in its building. Each elevator bank contains three elevators. B pays an amount for labor and materials for work performed on the elevators. Under paragraph (e)(2)(i) of this section, B must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Under paragraph (e)(2)(ii)(B)(*5*) of this section, all six elevators, including all their components, comprise a building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by B for work on the elevators is an improvement (for example, a betterment) to the elevator system, B must treat this amount as an improvement to the building.

Example 3. Building structure and systems; condominium C owns a condominium unit in a condominium office building. C uses the condominium unit in its business of providing medical services. The condominium unit contains two restrooms, each of which contains a sink, a toilet, water and drainage pipes and other bathroom fixtures. C pays an amount for labor and materials to perform work on the pipes, sinks, toilets, and plumbing fixtures that are part of the condominium. Under paragraph (e)(2)(iii) of this section, C must treat the individual unit that it owns, including the structural components that are part of that unit, as a single unit of property. As provided under paragraph (e)(2)(iii)(B) of this section, an amount is paid to improve the condominium if it is for an improvement to the building structure that is part of the condominium or to a portion of any designated building system that is part of the condominium. Under paragraph (e)(2)(ii)(B)(*2*) of this section, the pipes, sinks, toilets, and plumbing fixtures that are part of C's condominium comprise the plumbing system for the condominium. Therefore, under paragraph (e)(2)(iii) of this section, if an amount paid by C for work on pipes, sinks, toilets, and plumbing fixtures is an improvement (for example, a betterment) to the portion of the plumbing system that is part of C's condominium, C must treat this amount as an improvement to the condominium.

Example 4. Building structure and systems; property other than buildings D, a manufacturer, owns a building adjacent to its manufacturing facility that contains office space and related facilities for D's employees that manage and administer D's manufacturing operations. The office building contains equipment, such as desks, chairs, computers, telephones, and bookshelves that are not building structure or building systems. D pays an amount to add an extension to the office building. Under paragraph (e)(2)(i) of this section, D must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system. Therefore, under paragraph (e)(2)(ii) of this section, if an amount paid by D for the addition of an extension to the office building is an improvement (for example, a betterment) to the building structure or any of the building systems, D must treat this amount as an improvement to the building. In addition, because the equipment contained within the office building constitutes property other than the building, the units of property for the office equipment are initially determined under paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent (for example, each desk, each chair, and each book shelf).

Example 5. Plant property; discrete and major function E is an electric utility company that operates a power plant to generate electricity. The power plant includes a structure that is not a building under §1.48–1(e)(1), and, among other things, one pulverizer that grinds coal, a single boiler that produces steam, one turbine that converts the steam into mechanical energy, and one generator that converts mechanical energy into electrical energy. In addition, the turbine contains a series of blades that cause the turbine to rotate when affected by the steam. Because the plant is composed of real and personal tangible property other than a building, the unit of property for the generating equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire plant because the components of the plant are functionally interdependent. However, because the power plant is plant property under paragraph (e)(3)(ii) of this section, the initial unit of property is further divided into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the plant. Under this paragraph, E must treat the structure, the boiler, the turbine, the generator, and the pulverizer each as a separate unit of property because each of these components performs a discrete and major function within the power plant. E may not treat components, such as the turbine blades, as separate units of property because each of these components does not perform a discrete and major function within the plant.

Example 6. Plant property; discrete and major function F is engaged in a uniform and linen rental business. F owns and operates a plant that utilizes many different machines and equipment in an assembly line-like process to treat, launder, and prepare rental items for its customers. F utilizes two laundering lines in its plant, each of which can operate independently. One line is used for uniforms and another line is used for linens. Both lines incorporate a sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system. Because the laundering equipment contained within the plant is property other than a building, the unit of property for the laundering equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial units of property are each laundering line because each line is functionally independent and is comprised of components that are functionally interdependent. However, because each line is comprised of plant property under paragraph (e)(3)(ii) of this section, F must further divide these initial units of property into smaller units of property by determining the components (or groups of components) that perform discrete and major functions within the line. Under paragraph (e)(3)(ii) of this section, F must treat each sorter, boiler, washer, dryer, ironer, folder, and waste water treatment system in each line as a separate unit of property because each of these components performs a discrete and major function within the line.

Example 7. Plant property; industrial process G operates a restaurant that prepares and serves food to retail customers. Within its restaurant, G has a large piece of equipment that uses an assembly line-like process to prepare and cook tortillas that G serves only to its restaurant customers. Because the tortilla-making equipment is property other than a building, the unit of property for the equipment is initially determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of all the components that are functionally interdependent. Under this rule, the initial unit of property is the entire tortilla-making equipment because the various components of the equipment are functionally interdependent. The equipment is not plant property under paragraph (e)(3)(ii) of this section because the equipment is not used in an industrial process, as it performs a small-scale function in G's restaurant operations. Thus, G is not required to further divide the equipment into separate units of property based on the components that perform discrete and major functions.

Example 8. Personal property H owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries, and trucks. H acquired a locomotive with all its components. Because H's locomotive is property other than a building, the initial unit of property is determined under the general rule in paragraph (e)(3)(i) of this section and is comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the locomotive is a single unit of property because it consists entirely of components that are functionally interdependent.

Example 9. Personal property J provides legal services to its clients. J purchased a laptop computer and a printer for its employees to use in providing legal services. Because the computer and printer are property other than a building, the initial units of property are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of the components that are functionally interdependent. Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

Example 10. Building structure and systems; leased building K is a retailer of consumer products. K conducts its retail sales in a building that it leases from L. The leased building consists of the building structure (including the floor, walls, and roof) and various building systems, including a plumbing system, an electrical system, an HVAC system, a security system, and a fire protection and prevention system. K pays an amount for labor and materials to perform work on the HVAC system of the leased building. Under paragraph (e)(2)(v)(A) of this section, because K leases the entire building, K must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property if it is for an improvement (for example, a betterment) to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, if an amount paid by K for work on the HVAC system is for an improvement to the HVAC system in the leased building, K must treat this amount as an improvement to the entire leased building property.

Example 11. Production of real property related to leased property Assume the same facts as in *Example 10*, except that K receives a construction allowance from L, and K uses the construction allowance to build a driveway adjacent to the leased building. Assume that under the terms of the lease, K, the lessee, is treated as the owner of any property that it constructs on or nearby the leased building. Also assume that section 110 does not apply to the construction allowance. Finally, assume that the driveway is not plant property or a network asset. Because the construction of the driveway consists of the production of real property other than a building, all the components of the driveway are functionally interdependent and are a single unit of property under paragraphs (e)(3)(i) and (e)(3)(iv) of this section.

Example 12. Leasehold improvements; construction allowance used for lessor-owned improvements Assume the same facts as *Example 11*, except that, under the terms of the lease, L, the lessor, is treated as the owner of any property constructed on the leased premises. Because L, the lessor, is the owner of the driveway and the driveway is real property other than a building, all the components of the driveway are functionally interdependent and are a single unit of property under paragraph (e)(3)(i) of this section.

Example 13. Buildings and structural components; leased office space M provides consulting services to its clients. M conducts its consulting services business in two office spaces in the same building, each of which it leases from N under separate lease agreements. Each office space contains a separate HVAC system, which is part of the leased property. Both lease agreements provide that M is responsible for maintaining, repairing, and replacing the HVAC system that is part of the leased property. M pays amounts to perform work on the HVAC system in each office space. Because M leases two separate office spaces subject to two leases, M must treat the portion of the building structure and the structural components subject to each lease as a separate unit of property under paragraph (e)(2)(v)(A) of this section. As provided under paragraph (e)(2)(v)(B) of this section, an amount is paid to improve a leased building property, if it is for an improvement to the leased portion of the building structure or the portion of any designated building system subject to each lease. Under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii)(B)(*1*) of this section, M must treat the HVAC system associated with each leased office space as a building system of that leased building property. Thus, M must treat the HVAC system associated with the first leased office space as a building system of the first leased office space and the HVAC system associated with the second leased office space as a building system of the second leased office space. Under paragraph (e)(2)(v)(B) of this section, if the amount paid by M for work on the HVAC system in one leased office space is for an improvement (for example, a betterment) to the HVAC system that is part of that leased space, then M must treat the amount as an improvement to that individual leased property.

Example 14. Leased property; personal property N is engaged in the business of transporting passengers on private jet aircraft. To conduct its business, N leases several aircraft from O. Under paragraph (e)(3)(iv) of this section (referencing paragraph (e)(3)(i) of this section), N must treat all of the components of each leased aircraft that are functionally interdependent as a single unit of property. Thus, N must treat each leased aircraft as a single unit of property.

Example 15. Improvement property (i) P is a retailer of consumer products. In Year 1, P purchases a building from Q, which P intends to use as a retail sales facility. Under paragraph (e)(2)(i) of this section, P must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is for an improvement to the building structure or any designated building system.

(ii) In Year 2, P pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that the extension involves the addition of walls, floors, roof, and doors, but does not include the addition or extension of any building systems described in paragraph (e)(2)(ii)(B) of this section. Also assume that the amount paid to build the extension is a betterment to the building structure under paragraph (j) of this section, and is therefore treated as an amount paid for an improvement to the entire building under paragraph (e)(2)(ii) of this section. Accordingly, P capitalizes the amount paid as an improvement to the building under paragraph (d) of this section. Under paragraph (e)(4) of this section, the extension is not a unit of property separate from the building, the unit of property improved. Thus, to determine whether any future expenditure constitutes an improvement to the building under paragraph (e)(2)(ii) of this section, P must determine whether the expenditure constitutes an improvement to the building structure, including the building extension, or to any of the designated building systems.

Example 16. Additional rules; year placed in service R is engaged in the business of transporting freight throughout the United States. To conduct its business, R owns a fleet of truck tractors and trailers. Each tractor and trailer is comprised of various components, including tires. R purchased a truck tractor with all of its components, including tires. The tractor tires have an average useful life to R of more than one year. At the time R placed the tractor in service, it treated the tractor tires as a separate asset for depreciation purposes under section 168. R properly treated the tractor (excluding the cost of the tires) as 3-year property and the tractor tires as 5-year property under section 168(e). Because R's tractor is property other than a building, the initial units of property for the tractor are determined under the general rule in paragraph (e)(3)(i) of this section and are comprised of all the components that are functionally interdependent. Under this rule, R must treat the tractor, including its tires, as a single unit of property because the tractor and the tires are functionally interdependent (that is, the placing in service of the tires is dependent upon the placing in service of the tractor). However, under paragraph (e)(5)(i) of this section, R must treat the tractor and tires as separate units of property because R properly treated the tires as being within a different class of property under section 168(e).

Example 17. Additional rules; change in subsequent year S is engaged in the business of leasing nonresidential real property to retailers. In Year 1, S acquired and placed in service a building for use in its retail leasing operation. In Year 5, to accommodate the needs of a new lessee, S incurred costs to improve the building structure. S capitalized the costs of the improvement under paragraph (d) of this section and depreciated the improvement in accordance with section 168(i)(6) as nonresidential real property under section 168(e). In Year 7, S determined that the structural improvement made in Year 5 qualified under section 168(e)(8) as qualified retail improvement property and, therefore, was 15-year property under section 168(e). In Year 7, S changed its method of accounting to use a 15-year recovery period for the improvement. Under paragraph (e)(5)(ii) of this section, in Year 7, S must treat the improvement as a unit of property separate from the building.

Example 18. Additional rules; change in subsequent year In Year 1, T acquired and placed in service a building and parking lot for use in its retail operations. Under §1.263(a)–2 of the regulations, T capitalized the cost of the building and the parking lot and began depreciating the building and the parking lot as nonresidential real property under section 168(e). In Year 3, T completed a cost segregation study under which it properly determined that the parking lot qualified as 15-year property under section 168(e). In Year 3, T changed its method of accounting for the parking lot to use a 15-year recovery period and the 150-percent declining balance method of depreciation. Under paragraph (e)(5)(ii) of this section, beginning in Year 3, T must treat the parking lot as a unit of property separate from the building.

Example 19. Additional rules; change in subsequent year In Year 1, U acquired and placed in service a building for use in its manufacturing business. U capitalized the costs allocable to the building's wiring separately from the building and depreciated the wiring as 7-year property under section 168(e). U capitalized the cost of the building and all other structural components of the building and began depreciating them as nonresidential real property under section 168(e). In Year 3, U completed a cost segregation study under which it properly determined that the wiring is a structural component of the building and, therefore, should have been depreciated as nonresidential real property. In Year 3, U changed its method of accounting to treat the wiring as nonresidential real property. Under paragraph (e)(5)(ii) of this section, U must change the unit of property for the wiring in a manner that is consistent with the change in treatment for depreciation purposes. Therefore, U must change the unit of property for the wiring to treat it as a structural component of the building, and as part of the building unit of property, in accordance with paragraph (e)(2)(i) of this section.

(f) *Improvements to leased property*—(1) *In general*. Except as provided in paragraph (h) of this section (safe harbor for small taxpayers) and under §1.263(a)–1(f) (de minimis safe harbor), this paragraph (f) provides the exclusive rules for determining whether amounts paid by a taxpayer are for an improvement to a leased property and must be capitalized. In the case of a leased building or a leased portion of a building, an amount is paid to improve a leased property if the amount is paid for an improvement to any of the properties specified in paragraph (e)(2)(ii) of this section (for lessor improvements) or in paragraph (e)(2)(v)(B) of this section (for lessee improvements, except as provided in paragraph (f)(2)(ii) of this section). Section 1.263(a)–4 does not apply to amounts paid for improvements to leased property or to amounts paid for the acquisition or production of leasehold improvement property.

(2) *Lessee improvements*—(i) *Requirement to capitalize*. A taxpayer lessee must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays to improve, as defined under paragraph (d) of this section, a leased property except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement or when the improvement constitutes a substitute for rent. See §1.61–8(c) for the treatment of lessee expenditures that constitute a substitute for rent. A taxpayer lessee must also capitalize the related amounts that a lessor pays to improve, as defined under paragraph (d) of this section, a leased property if the lessee is the owner of the improvement, except to the extent that section 110 applies to a construction allowance received by the lessee for the purpose of such improvement. An amount paid for a lessee improvement under this paragraph (f)(2)(i) is treated as an amount paid to acquire or produce a unit of real or personal property under §1.263(a)–2(d)(1) of the regulations.

(ii) *Unit of property for lessee improvements*. For purposes of determining whether an amount paid by a lessee constitutes a lessee improvement to a leased property under paragraph (f)(2)(i) of this section, the unit of property and the improvement rules are applied to the leased property in accordance with paragraph (e)(2)(v) (leased buildings) or paragraph (e)(3)(iv) (leased property other than buildings) of this section and include previous lessee improvements. However, if a lessee improvement is comprised of an entire building erected on leased property, then the unit of property for the building and the application of the improvement rules to the building are determined under paragraphs (e)(2)(i) and (e)(2)(ii) of this section.

(3) *Lessor improvements*—(i) *Requirement to capitalize.* A taxpayer lessor must capitalize the related amounts, as determined under paragraph (g)(3) of this section, that it pays directly, or indirectly through a construction allowance to the lessee, to improve, as defined in paragraph (d) of this section, a leased property when the lessor is the owner of the improvement or to the extent that section 110 applies to the construction allowance. A lessor must also capitalize the related amounts that the lessee pays to improve a leased property, as defined in paragraph (e) of this section, when the lessee's improvement constitutes a substitute for rent. See §1.61–8(c) for treatment of expenditures by lessees that constitute a substitute for rent. Amounts capitalized by the lessor under this paragraph (f)(3)(i) may not be capitalized by the lessee. If a lessor improvement is comprised of an entire building erected on leased property, then the amount paid for the building is treated as an amount paid by the lessor to acquire or produce a unit of property under §1.263(a)–2(d)(1). See paragraph (e)(2) of this section for the unit of property for a building and paragraph (e)(3) of this section for the unit of property for real or personal property other than a building.

(ii) *Unit of property for lessor improvements.* In general, an amount capitalized as a lessor improvement under paragraph (f)(3)(i) of this section is not a unit of property separate from the unit of property improved. See paragraph (e)(4) of this section. However, if a lessor improvement is comprised of an entire building erected on leased property, then the unit of property for the building and the application of the improvement rules to the building are determined under paragraphs (e)(2)(i) and (e)(2)(ii) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (f) and do not address whether capitalization is required under another provision of the Code (for example, section 263A). For purposes of the following examples, assume that section 110 does not apply to the lessee and the amounts paid by the lessee are not a substitute for rent.

Example 1. Lessee improvements; additions to building (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. The leased building consists of the building structure under paragraph (e)(2)(ii)(A) of this section and various building systems under paragraph (e)(2)(ii)(B) of this section, including a plumbing system, an electrical system, and an HVAC system. Under the terms of the lease, T is permitted to improve the building at its own expense. Under paragraph (e)(2)(v)(A) of this section, because T leases the entire building, T must treat the leased building and its structural components as a single unit of property. As provided under paragraph (e)(2)(v)(B)(*1*) of this section, an amount is paid to improve a leased building property if the amount is paid for an improvement to the leased building structure or to any building system within the leased building. Therefore, under paragraphs (e)(2)(v)(B)(*1*) and (e)(2)(ii) of this section, if T pays an amount that improves the building structure, the plumbing system, the electrical system, or the HVAC system, then T must treat this amount as an improvement to the entire leased building property.

(ii) In Year 2, T pays an amount to construct an extension to the building to be used for additional warehouse space. Assume that this amount is for a betterment (as defined under paragraph (j) of this section) to T's leased building structure and does not affect any building systems. Accordingly, the amount that T pays for the building extension is for a betterment to the leased building structure, and thus, under paragraph (e)(2)(v)(B)(*1*) of this section, is treated as an improvement to the entire leased building under paragraph (d) of this section. Because T, the lessee, paid an amount to improve a leased building property, T is required to capitalize the amount paid for the building extension as a leasehold improvement under paragraph (f)(2)(i) of this section. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under § 1.263(a)–2(d)(1).

(iii) In Year 5, T pays an amount to add a large overhead door to the building extension that it constructed in Year 2 to accommodate the loading of larger products into the warehouse space. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased property. Therefore, under paragraph (e)(2)(v)(A) of this section, the unit of property is the entire leased building, including the extension built in Year 2. In addition, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system. Assume that the amount paid to add the overhead door is for a betterment, under paragraph (j) of this section, to the building structure, which includes the extension. Accordingly, T must capitalize the amounts paid to add the overhead door as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the improvement as the acquisition or production of a unit of property (leasehold improvement property) under §1.263(a)–2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new overhead door.

Example 2. Lessee improvements; additions to certain structural components of buildings (i) Assume the same facts as *Example 1* except that in Year 2, T also pays an amount to construct an extension of the HVAC system into the building extension. Assume that the extension is a betterment, under paragraph (j) of this section, to the leased HVAC system (a building system under paragraph (e)(2)(ii)(B)(*1*) of this section). Accordingly, the amount that T pays for the extension of the HVAC system is for a betterment to the leased building system, the HVAC system, and thus, under paragraph (e)(2)(v)(B)(*1*) of this section, is treated as an improvement to the entire leased building property under paragraph (d) of this section. Because T, the lessee, pays an amount to improve a leased building property, T is required to capitalize the amount paid as a leasehold improvement under paragraph (f)(2)(i) of this section. Under paragraph (f)(2)(i) of this section, T must treat the amount paid for the HVAC extension as the acquisition and production of a unit of property (leasehold improvement property) under § 1.263(a)–2(d)(1).

(ii) In Year 5, T pays an amount to add an additional chiller to the portion of the HVAC system that it constructed in Year 2 to accommodate the climate control requirements for new product offerings. Under paragraph (f)(2)(ii) of this section, to determine whether the amount paid by T is for a leasehold improvement, the unit of property and the improvement rules are applied in accordance with paragraph (e)(2)(v) of this section and include T's previous improvements to the leased building property. Therefore, under paragraph (e)(2)(v)(B) of this section, the leased building property is improved if the amount is paid for an improvement to the building structure or any building system. Assume that the amount paid to add the chiller is for a betterment, under paragraph (j) of this section, to the HVAC system, which includes the extension of the system in Year 2. Accordingly, T must capitalize the amounts paid to add the chiller as a leasehold improvement to the leased building property. In addition, paragraph (f)(2)(i) of this section requires T to treat the amount paid for the chiller as the acquisition or production of a unit of property (leasehold improvement property) under §1.263(a)–2(d)(1). However, to determine whether a future amount paid by T is for a leasehold improvement to the leased building, the unit of property and the improvement rules are again applied in accordance with paragraph (e)(2)(v) of this section and include the new chiller.

Example 3. Lessor Improvements; additions to building (i) T is a retailer of consumer products. In Year 1, T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T intends to use to construct an extension to the retail sales facility for additional warehouse space. Assume that the amount paid for any improvement to the building does not exceed the construction allowance and that L is treated as the owner of any improvement to the building. Under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. As provided under paragraph (e)(2)(ii) of this section, an amount is paid to improve a building if it is paid for an improvement to the building structure or to any building system.

(ii) In Year 2, T uses L's construction allowance to construct an extension to the leased building to provide additional warehouse space in the building. Assume that the extension is a betterment (as defined under paragraph (j) of this section) to the building structure, and therefore, the amount paid for the extension results in an improvement to the building under paragraph (d) of this section. Under paragraph (f)(3)(i) of this section, L, the lessor and owner of the improvement, must capitalize the amounts paid to T to construct the extension to the retail sales facility. T is not permitted to capitalize the amounts paid for the lessor-owned improvement. Finally, under paragraph (f)(3)(ii) of this section, the extension to L's building is not a unit of property separate from the building and its structural components.

Example 4. Lessee property; personal property added to leased building T is a retailer of consumer products. T leases a building from L, which T intends to use as a retail sales facility. Pursuant to the lease, L provides a construction allowance to T, which T uses to acquire and construct partitions for fitting rooms, counters, and shelving. Assume that each partition, counter, and shelving unit is a unit of property under paragraph (e)(3) of this section. Assume that for Federal income tax purposes T is treated as the owner of the partitions, counters, and shelving. T's expenditures for the partitions, counters, and shelving are not improvements to the leased property under paragraph (d) of this section, but rather constitute amounts paid to acquire or produce separate units of personal property under §1.263(a)–2(d)(1).

Example 5. Lessor property; buildings on leased property L is the owner of a parcel of unimproved real property that L leases to T. Pursuant to the lease, L provides a construction allowance to T of $500,000, which T agrees to use to construct a building costing not more than $500,000 on the leased real property and to lease the building from L after it is constructed. Assume that for Federal income tax purposes, L is treated as the owner of the building that T will construct. T uses the $500,000 to construct the building as required under the lease. The building consists of the building structure and the following building systems: (1) a plumbing system; (2) an electrical system; and (3) an HVAC system. Because L provides a construction allowance to T to construct a building and L is treated as the owner of the building, L must capitalize the amounts that it pays indirectly to T to construct the building as a lessor improvement under paragraph (f)(3)(i) of this section. In addition, the amounts paid by L for the construction allowance are treated as amounts paid by L to acquire and produce the building under §1.263(a)–2(d)(1). Further, under paragraph (e)(2)(i) of this section, L must treat the building and its structural components as a single unit of property. Under paragraph (f)(3)(i) of this section, T, the lessee, may not capitalize the amounts paid (with the construction allowance received from L) for construction of the building.

Example 6. Lessee contribution to construction costs Assume the same facts as in *Example 5*, except T spends $600,000 to construct the building. T uses the $500,000 construction allowance provided by L plus $100,000 of its own funds to construct the building that L will own pursuant to the lease. Also assume that the additional $100,000 that T pays is not a substitute for rent. For the reasons discussed in *Example 5*, L must capitalize the $500,000 it paid T to construct the building under §1.263(a)–2(d)(1). In addition, because T spends its own funds to complete the building, T has a depreciable interest of $100,000 in the building and must capitalize the $100,000 it paid to construct the building as a leasehold improvement under §1.263(a)–2(d)(1) of the regulations. Under paragraph (e)(2)(i) of this section, L must treat the building as a single unit of property to the extent of its depreciable interest of $500,000. In addition, under paragraphs (f)(2)(ii) and (e)(2)(i) of this section, T must also treat the building as a single unit of property to the extent of its depreciable interest of $100,000.

(g) *Special rules for determining improvement costs*—(1) *Certain costs incurred during an improvement*—(i) *In general*. A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement. Indirect costs arising from activities that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether the activities are performed at the same time as an improvement.

(ii) *Exception for individuals' residences*. A taxpayer who is an individual may capitalize amounts paid for repairs and maintenance that are made at the same time as capital improvements to units of property not used in the taxpayer's trade or business or for the production of income if the amounts are paid as part of an improvement (for example, a remodeling) of the taxpayer's residence.

(2) *Removal costs*—(i) *In general*. If a taxpayer disposes of a depreciable asset, including a partial disposition under Prop. Reg. §1.168(i)–1(e)(2)(ix) (September 19, 2013), or §1.168(i)–8(d), for Federal income tax purposes and has taken into account the adjusted basis of the asset or component of the asset in realizing gain or loss, then the costs of removing the asset or component are not required to be capitalized under this section. If a depreciable asset is included in a general asset account under section 168(i)(4), and neither the regulations under section 168(i)(4) and §1.168(i)–1(e)(3), apply to a

disposition of such asset, or a portion of such asset under §1.168(i)–1(e)(1)(ii), a loss is treated as being realized in the amount of zero upon the disposition of the asset solely for purposes of this paragraph (g)(2)(i). If a taxpayer disposes of a component of a unit of property, but the disposal of the component is not a disposition for Federal tax purposes, then the taxpayer must deduct or capitalize the costs of removing the component based on whether the removal costs directly benefit or are incurred by reason of a repair to the unit of property or an improvement to the unit of property. But see §1.280B–1 for the rules applicable to demolition of structures.

(ii) *Examples.* Thefollowing examples illustrate the application of paragraph (g)(2)(i) of this section and, unless otherwise stated, do not address whether capitalization is required under another provision of this section or another provision of the Code (for example, section 263A). For purposes of the following examples, assume that §1.168(i)–1(e) or §1.168(i)–8, applies and that §1.280B–1 does not apply.

Example 1. Component removed during improvement; no disposition X owns a factory building with a storage area on the second floor. X pays an amount to remove the original columns and girders supporting the second floor and replace them with new columns and girders to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Assume that the replacement of the columns and girders constitutes a betterment to the building structure and is therefore an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section. Assume that X disposes of the original columns and girders and the disposal of these structural components is not a disposition under §1.168(i)–1(e) or §1.168(i)–8. Under paragraphs (g)(2)(i) and (j) of this section, the amount paid to remove the columns and girders must be capitalized as a cost of the improvement, because it directly benefits and is incurred by reason of the improvement to the building.

Example 2. Component removed during improvement; disposition Assume the same facts as *Example 1,* except X disposes of the original columns and girders and elects to treat the disposal of these structural components as a partial disposition of the factory building under §1.168(i)–8(d), taking into account the adjusted basis of the components in realizing loss on the disposition. Under paragraph (g)(2)(i) of this section, the amount paid to remove the columns and girders is not required to be capitalized as part of the cost of the improvement regardless of their relation to the improvement. However, all the remaining costs of replacing the columns and girders must be capitalized as improvements to the building unit of property under paragraphs (d)(1), (j), and (g)(1) of this section.

Example 3. Component removed during repair or maintenance; no disposition Y owns a building in which it conducts its retail business. The roof over Y's building is covered with shingles. Over time, the shingles begin to wear and Y begins to experience leaks into its retail premises. However, the building still functions in Y's business. To eliminate the problems, a contractor recommends that Y remove the original shingles and replace them with new shingles. Accordingly, Y pays the contractor to replace the old shingles with new but comparable shingles. The new shingles are comparable to original shingles but correct the leakage problems. Assume that replacement of old shingles with new shingles to correct the leakage is not a betterment or a restoration of the building structure or systems under paragraph (j) or (k) of this section and does not adapt the building structure or systems to a new or different use under paragraph (l) of this section. Thus, the amounts paid by Y to replace the shingles are not improvements to the building unit of property under paragraph (d) of this section. Under paragraph (g)(2)(i) of this section, the amounts paid to remove the shingles are not required to be capitalized because they directly benefit and are incurred by reason of repair or maintenance to the building structure.

Example 4. Component removed with disposition and restoration Assume the same facts as *Example 3* except Y disposes of the original shingles, and Y elects to treat the disposal of these components as a partial disposition of the building under §1.168(i)–8(d), and deducts the adjusted basis of the components as a loss on the disposition. Under paragraph (k)(1)(i) of this section, amounts paid for replacement of the shingles constitute a restoration of the building structure because the amounts are paid for the replacement of a component of the structure and the taxpayer has properly deducted a loss for that component. Thus, under paragraphs (d)(2) and (k) of this section, Y is required to capitalize the amounts paid for the replacement of the shingles as an improvement to the building unit of property. However, under paragraph (g)(2)(i) of this section, the amounts paid by Y to remove the original shingles are not required to be capitalized as part of the costs of the improvement, regardless of their relation to the improvement.

(3) *Related amounts*. For purposes of paragraph (d) of this section, amounts paid to improve a unit of property include amounts paid over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed.

(4) *Compliance with regulatory requirements*. For purposes of this section, a Federal, state, or local regulator's requirement that a taxpayer perform certain repairs or maintenance on a unit of property to continue operating the property is not relevant in determining whether the amount paid improves the unit of property.

(h) *Safe harbor for small taxpayers*—(1) *In general*. A qualifying taxpayer (as defined in paragraph (h)(3) of this section) may elect to not apply paragraph (d) or paragraph (f) of this section to an eligible building property (as defined in paragraph (h)(4) of this section) if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the eligible building property does not exceed the lesser of—

(i) 2 percent of the unadjusted basis (as defined under paragraph (h)(5) of this section) of the eligible building property; or

(ii) $10,000.

(2) *Application with other safe harbor provisions*. For purposes of paragraph (h)(1) of this section, amounts paid for repairs, maintenance, improvements, and similar activities performed on eligible building property include those amounts not capitalized under the de minimis safe harbor election under §1.263(a)-1(f) and those amounts deemed not to improve property under the safe harbor for routine maintenance under paragraph (i) of this section.

(3) *Qualifying taxpayer*—(i) *In general*. For purposes of this paragraph (h), the term *qualifying taxpayer* means a taxpayer whose average annual gross receipts as determined under this paragraph (h)(3) for the three preceding taxable years is less than or equal to $10,000,000.

(ii) *Application to new taxpayers*. If a taxpayer has been in existence for less than three taxable years, the taxpayer determines its average annual gross receipts for the number of taxable years (including short taxable years) that the taxpayer (or its predecessor) has been in existence.

(iii) *Treatment of short taxable year*. In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by—

(A) Multiplying the gross receipts for the short period by 12; and

(B) Dividing the product determined in paragraph (h)(3)(iii)(A) of this section by the number of months in the short period.

(iv) *Definition of gross receipts*. For purposes of applying paragraph (h)(3)(i) of this section, the term *gross receipts* means the taxpayer's receipts for the taxable year that are properly recognized under the taxpayer's methods of accounting used for Federal income tax purposes for the taxable year. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221(a)(1), (3), (4), or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in section 1221(a)(2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (for example, a repayment of the principal amount of a loan held by a commercial lender) and, except to the extent of gain recognized, do not include gross receipts derived from a non-recognition transaction, such as a section 1031 exchange. Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts include the amounts received that are allocable to the payment of such tax.

(4) *Eligible building property.* For purposes of this section, the term *eligible building property* refers to each unit of property defined in paragraph (e)(2)(i) (building), paragraph (e)(2)(iii)(A) (condominium), paragraph (e)(2)(iv)(A) (cooperative), or paragraph (e)(2)(v)(A) (leased building or portion of building) of this section, as applicable, that has an unadjusted basis of $1,000,000 or less.

(5) *Unadjusted basis*—(i) *Eligible building property owned by taxpayer.* For purposes of this section, the unadjusted basis of eligible building property owned by the taxpayer means the basis as determined under section 1012, or other applicable sections of Chapter 1, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3) or to amounts for which the taxpayer has elected to treat as an expense (for example, under sections 179, 179B, or 179C).

(ii) *Eligible building property leased to the taxpayer.* For purposes of this section, the unadjusted basis of eligible building property leased to the taxpayer is the total amount of (undiscounted) rent paid or expected to be paid by the lessee under the lease for the entire term of the lease, including renewal periods if all the facts and circumstances in existence during the taxable year in which the lease is entered indicate a reasonable expectancy of renewal. Section 1.263(a)–4(f)(5)(ii) provides the factors that are significant in determining whether there exists a reasonable expectancy of renewal for purposes of this paragraph.

(6) *Time and manner of election.* A taxpayer makes the election described in paragraph (h)(1) of this section by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which amounts are paid for repairs, maintenance, improvements, and similar activities performed on the eligible building property providing that such amounts qualify under the safe harbor provided in paragraph (h)(1) of this section. Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled, "Section 1.263(a)–3(h) Safe Harbor Election for Small Taxpayers" and include the taxpayer's name, address, taxpayer identification number, and a description of each eligible building property to which the taxpayer is applying the election. In the case of an S corporation or a partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. A taxpayer may not revoke an election made under this paragraph (h). The time and manner of making the election under this paragraph (h) may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter).

(7) *Treatment of safe harbor amounts.* Amounts paid by the taxpayer for repairs, maintenance, improvements, and similar activities to which the taxpayer properly applies the safe harbor under paragraph (h)(1) of this section and for which the taxpayer properly makes the election under paragraph (h)(6) of this section are not treated as improvements under paragraph (d) or (f) of this section and may be deducted under § 1.162–1 or § 1.212–1, as applicable, in the taxable year these amounts are paid, provided the amounts otherwise qualify for a deduction under these sections.

(8) *Safe harbor exceeded.* If total amounts paid by a qualifying taxpayer during the taxable year for repairs, maintenance, improvements, and similar activities performed on an eligible

building property exceed the safe harbor limitations specified in paragraph (h)(1) of this section, then the safe harbor election is not available for that eligible building property and the taxpayer must apply the general improvement rules under this section to determine whether amounts are for improvements to the unit of property, including the safe harbor for routine maintenance under paragraph (i) of this section. The taxpayer may also elect to apply the de minimis safe harbor under §1.263(a)–1(f) to amounts qualifying under that safe harbor irrespective of the application of this paragraph (h).

(9) *Modification of safe harbor amounts.* The amount limitations provided in paragraphs (h)(1)(i), (h)(1)(ii), and (h)(3) of this section may be modified through published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(10) *Examples.* The following examples illustrate the rules of this paragraph (h). Assume that §1.212–1 does not apply to the amounts paid.

Example 1. Safe harbor for small taxpayers applicable A is a qualifying taxpayer under paragraph (h)(3) of this section. A owns an office building in which A provides consulting services. In Year 1, A's building has an unadjusted basis of $750,000 as determined under paragraph (h)(5)(i) of this section. In Year 1, A pays $5,500 for repairs, maintenance, improvements and similar activities to the office building. Because A's building unit of property has an unadjusted basis of $1,000,000 or less, A's building constitutes eligible building property under paragraph (h)(4) of this section. The aggregate amount paid by A during Year 1 for repairs, maintenance, improvements and similar activities on this eligible building property does not exceed the lesser of $15,000 (2 percent of the building's unadjusted basis of $750,000) or $10,000. Therefore, under paragraph (h)(1) of this section, A may elect to not apply the capitalization rule of paragraph (d) of this section to the amounts paid for repair, maintenance, improvements, or similar activities on the office building in Year 1. If A properly makes the election under paragraph (h)(6) of this section for the office building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on a trade or business, A may deduct these amounts under §1.162–1 in Year 1.

Example 2. Safe harbor for small taxpayers inapplicable Assume the same facts as in *Example 1,* except that A pays $10,500 for repairs, maintenance, improvements, and similar activities performed on its office building in Year 1. Because this amount exceeds $10,000, the lesser of the two limitations provided in paragraph (h)(1) of this section, A may not apply the safe harbor for small taxpayers under paragraph (h)(1) of this section to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on the building. Therefore, A must apply the general improvement rules under this section to determine which of the aggregate amounts paid are for improvements and must be capitalized under paragraph (d) of this section and which of the amounts are for repair and maintenance under §1.162–4.

Example 3. Safe harbor applied building-by-building (i) B is a qualifying taxpayer under paragraph (h)(3) of this section. B owns two rental properties, Building M and Building N. Building M and Building N are both multi-family residential buildings. In Year 1, each property has an unadjusted basis of $300,000 under paragraph (h)(5) of this section. Because Building M and Building N each have an unadjusted basis of $1,000,000 or less, Building M and Building N each constitute eligible building property in Year 1 under paragraph (h)(4) of this section. In Year 1, B pays $5,000 for repairs, maintenance, improvements, and similar activities performed on Building M. In Year 1, B also pays $7,000 for repairs, maintenance, improvements, and similar activities performed on Building N.

(ii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building M ($5,000) does not exceed the lesser of $6,000 (2 percent of the building's unadjusted basis of $300,000) or $10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, B may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on Building M. If B properly makes the election under paragraph (h)(6) of this section for Building M and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on B's trade or business, B may deduct these amounts under §1.162–1.

(iii) The total amount paid by B during Year 1 for repairs, maintenance, improvements and similar activities on Building N ($7,000) exceeds $6,000 (2 percent of the building's unadjusted basis of $300,000), the lesser of the two limitations provided under paragraph (h)(1) of this section. Therefore, B may not apply the safe harbor under paragraph (h)(1) of this section to the total amounts paid for repairs, maintenance, improvements, and similar activities performed on Building N. Instead, B must apply the general improvement rules under this section to determine which of the total amounts paid for work performed on Building N are for improvements and must be capitalized under paragraph (d) of this section and which amounts are for repair and maintenance under §1.162–4.

Example 4. Safe harbor applied to leased building property C is a qualifying taxpayer under paragraph (h)(3) of this section. C is the lessee of a building in which C operates a retail store. The lease is a triple-net lease, and the lease term is 20 years, including reasonably expected renewals. C pays $4,000 per month in rent. In Year 1, C pays $7,000 for repairs, maintenance, improvements, and similar activities performed on the building. Under paragraph (h)(5)(ii) of this section, the unadjusted basis of C's leased unit of property is $960,000 ($4,000 monthly rent × 12 months × 20 years). Because C's leased building has an unadjusted basis of $1,000,000 or less, the building is eligible building property for Year 1 under paragraph (h)(4) of this section. The total amount paid by C during Year 1 for repairs, maintenance, improvements, and similar activities on the leased building ($7,000) does not exceed the lesser of $19,200 (2 percent of the building's unadjusted basis of $960,000) or $10,000. Therefore, under paragraph (h)(1) of this section, for Year 1, C may elect to not apply the capitalization rule under paragraph (d) of this section to the amounts it paid for repairs, maintenance, improvements, and similar activities on the leased building. If C properly makes the election under paragraph (h)(6) of this section for the leased building and the amounts otherwise constitute deductible ordinary and necessary expenses incurred in carrying on C's trade or business, C may deduct these amounts under §1.162–1.

(i) *Safe harbor for routine maintenance on property*—(1) *In general.* An amount paid for routine maintenance (as defined in paragraph (i)(1)(i) or (i)(1)(ii) of this section, as applicable) on a unit of tangible property, or in the case of a building, on any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or paragraph (e)(2)(v)(B) of this section, is deemed not to improve that unit of property.

(i) *Routine maintenance for buildings.* Routine maintenance for a building unit of property is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of any of the properties designated in paragraphs (e)(2)(ii), (e)(2)(iii)(B), (e)(2)(iv)(B), or (e)(2)(v)(B) of this section to keep the building structure or each building system in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the useful life of the building structure or building systems. However, the activities are routine only if the taxpayer reasonably expects to perform the activities more than once during the 10-year period beginning at the time the building structure or the building system upon which the routine maintenance is performed is placed in service by the taxpayer. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the 10-year period, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether a taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. With respect to a taxpayer that is a lessor of a building or a part of the building, the taxpayer's use of the building unit of property includes the lessee's use of its unit of property.

(ii) *Routine maintenance for property other than buildings.* Routine maintenance for property other than buildings is the recurring activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of damaged or worn parts of the unit of property with comparable and commercially available replacement parts. Routine maintenance may be performed any time during the useful life of the unit of property. However, the activities are routine only if, at the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the activities more than once during the class life (as defined in paragraph (i)(4) of this section) of the unit of property. A taxpayer's expectation will not be deemed unreasonable merely because the taxpayer does not actually perform the maintenance a second time during the class life of the unit of property, provided that the taxpayer can otherwise substantiate that its expectation was reasonable at the time the property was placed in service. Factors to be considered in determining whether maintenance is routine and whether the taxpayer's expectation is reasonable include the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical property. With respect to a taxpayer that is a lessor of a unit of property, the taxpayer's use of the unit of property includes the lessee's use of the unit of property.

(2) *Rotable and temporary spare parts.* Except as provided in paragraph (i)(3) of this section, for purposes of paragraph (i)(1)(ii) of this section, amounts paid for routine maintenance include routine maintenance performed on (and with regard to) rotable and temporary spare parts.

(3) *Exceptions.* Routine maintenance does not include the following:

(i) Amounts paid for a betterment to a unit of property under paragraph (j) of this section;

(ii) Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component (other than a casualty loss under §1.165–7) (see paragraph (k)(1)(i) of this section);

(iii) Amounts paid for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component (see paragraph (k)(1)(ii) of this section);

(iv) Amounts paid for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165, subject to the limitation in paragraph (k)(4) of this section (see paragraph (k)(1)(iii) of this section);

(v) Amounts paid to return a unit of property to its ordinarily efficient operating condition, if the property has deteriorated to a state of disrepair and is no longer functional for its intended use (see paragraph (k)(1)(iv) of this section);

(vi) Amounts paid to adapt a unit of property to a new or different use under paragraph (l) of this section;

(vii) Amounts paid for repairs, maintenance, or improvement of network assets (as defined in paragraph (e)(3)(iii)(A) of this section); or

(viii) Amounts paid for repairs, maintenance, or improvement of rotable and temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts under §1.162–3(e).

(4) *Class life.* The class life of a unit of property is the recovery period prescribed for the property under sections 168(g)(2) and (3) for purposes of the alternative depreciation system, regardless of whether the property is depreciated under section 168(g). For purposes of determining class life under this section, section 168(g)(3)(A) (relating to tax-exempt use property subject to lease) does not apply. If the unit of property is comprised of components with different class lives, then the class life of the unit of property is deemed to be the same as the component with the longest class life.

(5) *Coordination with section 263A.* Amounts paid for routine maintenance under this paragraph (i) may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of other property produced by the taxpayer or property acquired for resale. See, for example, §1.263A–1(e)(3)(ii)(O) requiring taxpayers to capitalize the cost of repairing equipment or facilities allocable to property produced or property acquired for resale.

(6) *Examples.* The following examples illustrate the application of this paragraph (i) and, unless otherwise stated, do not address the treatment under other provisions of the Code (for example, section 263A). In addition, unless

otherwise stated, assume that the taxpayer has not applied the optional method of accounting for rotable and temporary spare parts under §1.162–3(e).

Example 1. Routine maintenance on component (i) A is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, A owns or leases various types of aircraft. As a condition of maintaining its airworthiness certification for these aircraft, A is required by the Federal Aviation Administration (FAA) to establish and adhere to a continuous maintenance program for each aircraft within its fleet. These programs, which are designed by A and the aircraft's manufacturer and approved by the FAA, are incorporated into each aircraft's maintenance manual. The maintenance manuals require a variety of periodic maintenance visits at various intervals. One type of maintenance visit is an engine shop visit (ESV), which A expects to perform on its aircraft engines approximately every 4 years to keep its aircraft in its ordinarily efficient operating condition. In Year 1, A purchased a new aircraft, which included four new engines attached to the airframe. The four aircraft engines acquired with the aircraft are not materials or supplies under §1.162–3(c)(1)(i) because they are acquired as part of a single unit of property, the aircraft. In Year 5, A performs its first ESV on the aircraft engines. The ESV includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the engine and its component parts. During the ESV, the engine is removed from the aircraft and shipped to an outside vendor who performs the ESV. If inspection or testing discloses a discrepancy in a part's conformity to the specifications in A's maintenance program, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. After the ESVs, the engines are returned to A to be reinstalled on another aircraft or stored for later installation. Assume that the class life for A's aircraft, including the engines, is 12 years. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the costs of performing the ESVs.

(ii) Because the ESVs involve the recurring activities that A expects to perform as a result of its use of the aircraft to keep the aircraft in ordinarily efficient operating condition and consist of maintenance activities that A expects to perform more than once during the 12 year class life of the aircraft, A's ESVs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the ESVs are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 2. Routine maintenance after class life Assume the same facts as in *Example 1*, except that in year 15 A pays amounts to perform an ESV on one of the original aircraft engines after the end of the class life of the aircraft. Because this ESV involves the same routine maintenance activities that were performed on aircraft engines in *Example 1*, this ESV also is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for this ESV, even though performed after the class life of the aircraft, are deemed not to improve the aircraft and are not required to be capitalized under paragraph (d) of this section.

Example 3. Routine maintenance on rotable spare parts (i) Assume the same facts as in *Example 1*, except that in addition to the four engines purchased as part of the aircraft, A separately purchases four additional new engines that A intends to use in its aircraft fleet to avoid operational downtime when ESVs are required to be performed on the engines previously installed on an aircraft. Later in Year 1, A installs these four engines on an aircraft in its fleet. In Year 5, A performs the first ESVs on these four engines. Assume that these ESVs involve the same routine maintenance activities that were performed on the engines in *Example 1*, and that none of the exceptions set out in paragraph (i)(3) of this section apply to these ESVs. After the ESVs were performed, these engines were reinstalled on other aircraft or stored for later installation.

(ii) The additional aircraft engines are rotable spare parts under §1.162–3(c)(2) because they were acquired separately from the aircraft, are removable from the aircraft, and are repaired and reinstalled on other aircraft or stored for later installation. Assume the class life of an engine is the same as the airframe, 12 years. Because the ESVs involve the recurring activities that A expects to perform as a result of its use of the engines to keep the engines in ordinarily efficient operating condition, and consist of maintenance activities that A expects to perform more than once during the 12 year class life of the engine, the ESVs fall within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the ESVs for the four additional engines are deemed not to improve these engines and are not required to be capitalized under paragraph (d) of this section. For the treatment of amounts paid to acquire the engines, see §1.162–3(a).

Example 4. Routine maintenance resulting from prior owner's use (i) In January, Year 1, B purchases a used machine for use in its manufacturing operations. Assume that the machine is the unit of property and has a class life of 10 years. B places the machine in service in January, Year 1, and at that time, B expects to perform manufacturer recommended scheduled maintenance on the machine approximately every three years. The scheduled maintenance includes the cleaning and oiling of the machine, the inspection of parts for defects, and the replacement of minor items such as springs, bearings, and seals with comparable and commercially available replacement parts. At the time B purchased the machine, the machine was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, B pays amounts to perform the manufacturer recommended scheduled maintenance. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the scheduled maintenance.

(ii) The majority of B's costs do not qualify under the routine maintenance safe harbor in paragraph (i)(1)(ii) of this section because the costs were incurred primarily as a result of the prior owner's use of the property and not B's use. B acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amounts paid for the scheduled maintenance resulted from the prior owner's, and not B's, use of the property and must be capitalized if those amounts result in a betterment under paragraph (i) of this section, including the amelioration of a material condition or defect, or otherwise result in an improvement under paragraph (d) of this section.

Example 5. Routine maintenance resulting from new owner's use Assume the same facts as in *Example 4*, except that after B pays amounts for the maintenance in Year 1, B continues to operate the machine in its manufacturing business. In Year 4, B pays amounts to perform the next scheduled manufacturer recommended maintenance on the machine. Assume that the scheduled maintenance activities performed are the same as those performed in *Example 4* and that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the scheduled maintenance. Because the scheduled maintenance performed in Year 4 involves the recurring activities that B performs as a result of its use of the machine, keeps the machine in an ordinarily efficient operating condition, and consists of maintenance activities that B expects to perform more than once during the 10-year class life of the machine, B's scheduled maintenance costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance in Year 4 are deemed not to improve the machine and are not required to be capitalized under paragraph (d) of this section.

Example 6. Routine maintenance; replacement of substantial structural part; coordination with section 263A C is in the business of producing commercial products for sale. As part of the production process, C places raw materials into lined containers in which a chemical reaction is used to convert raw materials into the finished product. The lining, which comprises 60 percent of the total physical structure of the container, is a substantial structural part of the container. Assume that each container, including its lining, is the unit of property and that a container has a class life of 12 years. At the time that C placed the container into service, C was aware that approximately every three years, the container lining would need to be replaced with comparable and commercially available replacement materials. At the end of three years, the container will continue to function, but will become less efficient and the replacement of the lining will be necessary to keep the container in an ordinarily efficient operating condition. In Year 1, C acquired 10 new containers and placed them into service. In Year 4, Year 7, Year 9, and Year 12, C pays amounts to replace the containers' linings with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the replacement linings. Because the replacement of the linings involves recurring activities that C expects to perform as a result of its use of the containers to keep the containers in their ordinarily efficient operating condition and consists of maintenance activities that C expects to perform more than once during the 12-year class life of the containers, C's lining replacement costs are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts that C paid for the replacement of the container linings are deemed not to improve the containers and are not required to be capitalized under paragraph (d) of this section. However, the amounts paid to replace the lining may be subject to capitalization under section 263A if the amounts paid for this maintenance comprise the direct or allocable indirect costs of the property produced by C. See § 1.263A–1(e)(3)(ii)(O).

Example 7. Routine maintenance once during class life D is a Class I railroad that owns a fleet of freight cars. Assume that a freight car, including all its components, is a unit of property and has a class life of 14 years. At the time that D places a freight car into service, D expects to perform cyclical reconditioning to the car every 8 to 10 years to keep the freight car in ordinarily efficient operating condition. During this reconditioning, D pays amounts to disassemble, inspect, and recondition or replace components of the freight car with comparable and commercially available replacement parts. Ten years after D places the freight car in service, D pays amounts to perform a cyclical reconditioning on the car. Because D expects to perform the reconditioning only once during the 14 year class life of the freight car, the amounts D pays for the reconditioning do not qualify for the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, D must capitalize the amounts paid for the reconditioning of the freight car if these amounts result in an improvement under paragraph (d) of this section.

Example 8. Routine maintenance; reasonable expectation Assume the same facts as *Example 7*, except in Year 1, D acquires and places in service several refrigerated freight cars, which also have a class life of 14 years. Because of the special requirements of these cars, at the time they are placed in service, D expects to perform a reconditioning of the refrigeration components of the freight car every 6 years to keep the freight car in an ordinarily efficient operating condition. During the reconditioning, D pays amounts to disassemble, inspect, and recondition or replace the refrigeration components of the freight car with comparable and commercially available replacement parts. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the amounts paid for the reconditioning of these freight cars. In Year 6, D pays amounts to perform a reconditioning on the refrigeration components on one of the freight cars. However, because of changes in the frequency that D utilizes this freight car, D does not perform the second reconditioning on the same freight car until Year 15, after the end of the 14-year class life of the car. Under paragraph (i)(1)(ii) of this section, D's reasonable expectation that it would perform the reconditioning every 6 years will not be deemed unreasonable merely because D did not actually perform the reconditioning a second time during the 14-year class life, provided that D can substantiate that its expectation was reasonable at the time the property was placed in service. If D can demonstrate that its expectation was reasonable in Year 1 using the factors provided in paragraph (i)(1)(ii) of this section, then the amounts paid by D to recondition the refrigerated freight car components in Year 6 and in Year 15 are within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section.

Example 9. Routine maintenance on non-rotable part E is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. At the time that E places its towboats into service, E is aware that approximately every three to four years E will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available replacement parts. Assume the towboat engines are not rotable spare parts under §1.162–3(c)(2). In Year 1, E acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, E pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled maintenance costs. Because the scheduled maintenance involves recurring activities that E expects to perform more than once during the 18-year class life of the towboat, the maintenance results from E's use of the towboat, and the maintenance is performed to keep the towboat in an ordinarily efficient operating condition, the scheduled maintenance on E's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

Example 10. Routine maintenance with related betterments Assume the same facts as *Example 9*, except that in Year 9 E's towboat engines are due for another scheduled maintenance visit. At this time, E decides to upgrade the engines to increase their horsepower and propulsion, which would permit the towboats to tow heavier loads. Accordingly, in Year 9, E pays amounts to perform many of the same activities that it would perform during the typical scheduled maintenance activities such as cleaning, inspecting, reconditioning, and replacing minor parts, but at the same time, E incurs costs to upgrade certain engine parts to increase the towing capacity of the boats in excess of the capacity of the boats when E placed them in service. In combination with the replacement of parts with new and upgraded parts, the scheduled maintenance must be completed to perform the horsepower and propulsion upgrade. Thus, the work done on the engines encompasses more than the recurring activities that E expected to perform as a result of its use of the towboats and did more than keep the towboat in its ordinarily efficient operating condition. Rather under paragraph (j) of this section, the amounts paid to increase the horsepower and propulsion of the engines are for a betterment to the towboat, and such amounts are excepted from the routine maintenance safe harbor under paragraph (i)(3)(i) of this section. In addition, under paragraph (g)(1)(i) of this section, the scheduled maintenance procedures directly benefit the upgrades. Therefore, the amounts that E paid in Year 9 for the maintenance and upgrade of the engines do not qualify for the routine maintenance safe harbor described under paragraph (i)(1)(ii) of this section. Rather, E must capitalize the amounts paid for maintenance and upgrades of the engines as an improvement to the towboats under paragraph (d) of this section.

Example 11. Routine maintenance with unrelated improvements Assume the same facts as *Example 9*, except in Year 5, in addition to paying amounts to perform the scheduled engine maintenance on both engines, E also incurs costs to upgrade the communications and navigation systems in the pilot house of the towboat with new state-of-the-art systems. Assume the amounts paid to upgrade the communications and navigation systems are for betterments under paragraph (j) of this section, and therefore result in an improvement to the towboat under paragraph (d) of this section. In contrast with *Example 9*, the amounts paid for the scheduled maintenance on E's towboat engines are not otherwise related to the upgrades to the navigation systems. Because the scheduled maintenance on the towboat engines does not directly benefit and is not incurred by reason of the upgrades to the communication and navigation systems, the amounts paid for the scheduled engine maintenance are not a direct or indirect cost of the improvement under paragraph (g)(1)(i) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 5 are routine maintenance deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

Example 12. Exceptions to routine maintenance F owns and operates a farming and cattle ranch with an irrigation system that provides water for crops. Assume that each canal in the irrigation system is a single unit of property and has a class life of 20 years. At the time F placed the canals into service, F expected to have to perform major maintenance on the canals every three years to keep the canals in their ordinarily efficient operating condition. This maintenance includes draining the canals, and then cleaning, inspecting, repairing, and reconditioning or replacing parts of the canal with comparable and commercially available replacement parts. F placed the canals into service in Year 1 and did not perform any maintenance on the canals until Year 6. At that time, the canals had fallen into a state of disrepair and no longer functioned for irrigation. In Year 6, F pays amounts to drain the canals and do extensive cleaning, repairing, reconditioning, and replacing parts of the canals with comparable and commercially available replacement parts. Although the work performed on F's canals was similar to the activities that F expected to perform, but did not perform, every three years, the costs of these activities do not fall within the routine maintenance safe harbor. Specifically, under paragraph (i)(3)(v) of this section, routine maintenance does not include activities that return a unit of property to its former ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use. Accordingly, amounts that F pays for work performed on the canals in Year 6 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (k) of this section).

Example 13. Routine maintenance on a building; escalator system In Year 1, G acquires a large retail mall in which it leases space to retailers. The mall contains an escalator system with 40 escalators, which includes landing platforms, trusses, tracks, steps, handrails, and safety brushes. In Year 1, when G placed its building into service, G reasonably expected that it would need to replace the handrails on the escalators approximately every four years to keep the escalator system in its ordinarily efficient operating condition. After a routine inspection and test of the escalator system in Year 4, G determines that the handrails need to be replaced and pays an amount to replace the handrails with comparable and commercially available handrails. The escalator system, including the handrails, is a building system under paragraph (e)(2)(ii)(B)(*4*) of this section. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the scheduled maintenance costs. Because the replacement of the handrails involves recurring activities that G expects to perform as a result of its use of the escalator system to keep the escalator system in an ordinarily efficient operating condition, and G reasonably expects to perform these activities more than once during the 10-year period beginning at the time building system was placed in service, the amounts paid by G for the handrail replacements are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section. Accordingly, the amounts paid for the replacement of the handrails in Year 4 are deemed not to improve the building unit of property and are not required to be capitalized under paragraph (d) of this section.

Example 14. Not routine maintenance; escalator system Assume the same facts as in *Example 13*, except that in Year 9, G pays amounts to replace the steps of the escalators. In Year 1, when G placed its building into service, G reasonably expected that approximately every 18 to 20 years G would need to replace the steps to keep the escalator system in its ordinarily efficient operating condition. Because the replacement does not involve recurring activities that G expects to perform more than once during the 10-year period beginning at the time the building structure or the building system was placed in service, the costs of these activities do not fall within the routine maintenance safe harbor. Accordingly, amounts that G pays to replace the steps in Year 9 must be capitalized if they result in improvements under paragraph (d) of this section (for example, restorations under paragraph (k) of this section).

Example 15. Routine maintenance on building; reasonable expectation In Year 1, H acquires a new office building, which it uses to provide services. The building contains an HVAC system, which is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. In Year 1, when H placed its building into service, H reasonably expected that every four years H would need to pay an outside contractor to perform detailed testing, monitoring, and preventative maintenance on its HVAC system to keep the HVAC system in its ordinarily efficient operating condition. This scheduled maintenance includes disassembly, cleaning, inspection, repair, replacement, reassembly, and testing of the HVAC system and many of its component parts. If inspection or testing discloses a problem with any component, the part is repaired, or if necessary, replaced with a comparable and commercially available replacement part. The scheduled maintenance at these intervals is recommended by the manufacturer of the HVAC system and is routinely performed on similar systems in similar buildings. Assume that none of the exceptions in paragraph (i)(3) of this section apply to the amounts paid for the maintenance on the HVAC system. In Year 4, H pays amounts to a contractor to perform the scheduled maintenance. However, H does not perform this scheduled maintenance on its building again until Year 11. Under paragraph (i)(1)(i) of this section, H's reasonable expectation that it would perform the maintenance every 4 years will not be deemed unreasonable merely because H did not actually perform the maintenance a second time during the 10-year period, provided that H can substantiate that its expectation was reasonable at the time the property was placed in service. If H can demonstrate that its expectation was reasonable in Year 1 using the other factors considered in paragraph (i)(1)(i), then the amounts H paid for the maintenance of the HVAC system in Year 4 and in Year 11 are within the routine maintenance safe harbor under paragraph (i)(1)(i) of this section.

(j) *Capitalization of betterments*—(1) *In general.* A taxpayer must capitalize as an improvement an amount paid for a betterment to a unit of property. An amount is paid for a betterment to a unit of property only if it—

(i) Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;

(ii) Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component (as defined in paragraph (k)(6) of this section) to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or

(iii) Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

(2) *Application of betterment rules*—(i) *In general.* The applicability of each quantitative and qualitative factor provided in paragraphs (j)(1)(ii) and (j)(1)(iii) of this section to a particular unit of property depends on the nature of the unit of property. For example, if an addition or an increase in a particular factor cannot be measured in the context of a specific type of property, this factor is not relevant in the determination of whether an amount has been paid for a betterment to the unit of property.

(ii) *Application of betterment rules to buildings.* An amount is paid to improve a building if it is paid for a betterment, as defined under paragraph (j)(1) of this section, to a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of building) of this section. For example, an amount is paid to improve a building if it is paid for an increase in the efficiency of the building structure or any one of its building systems (for example, the HVAC system).

(iii) *Unavailability of replacement parts.* If a taxpayer replaces a part of a unit of property that cannot reasonably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.

(iv) *Appropriate comparison*—(A) *In general*. In cases in which an expenditure is necessitated by normal wear and tear or damage to the unit of property that occurred during the taxpayer's use of the unit of property, the determination of whether an expenditure is for the betterment of the unit of property is made by comparing the condition of the property immediately after the expenditure with the condition of the property immediately prior to the circumstances necessitating the expenditure.

(B) *Normal wear and tear*. If the expenditure is made to correct the effects of normal wear and tear to the unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.

(C) *Damage to property*. If the expenditure is made to correct damage to a unit of property that occurred during the taxpayer's use of the unit of property, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to damage.

(3) *Examples*. The following examples illustrate the application of this paragraph (j) only and do not address whether capitalization is required under another provision of this section or another provision of the Internal Revenue Code (for example, section 263A). Unless otherwise provided, assume that the appropriate comparison in paragraph (j)(2)(iv) of this section is not applicable under the facts.

Example 1. Amelioration of pre-existing material condition or defect In Year 1, A purchases a store located on a parcel of land that contains underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked prior to A's purchase, causing soil contamination. A is not aware of the contamination at the time of purchase. In Year 2, A discovers the contamination and incurs costs to remediate the soil. The remediation costs are for a betterment to the land under paragraph (j)(1)(i) of this section because A incurred the costs to ameliorate a material condition or defect that existed prior to A's acquisition of the land.

Example 2. Not amelioration of pre-existing condition or defect B owns an office building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. Several years after B places the building into service, B determines that certain areas of asbestos-containing insulation have begun to deteriorate and could eventually pose a health risk to employees. Therefore, B pays an amount to remove the asbestos-containing insulation from the building structure and replace it with new insulation that is safer to employees, but no more efficient or effective than the asbestos insulation. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Although the asbestos is determined to be unsafe under certain circumstances, the presence of asbestos insulation in a building, by itself, is not a preexisting material condition or defect of the building structure under paragraph (j)(1)(i) of this section. In addition, the removal and replacement of the asbestos is not for a material addition to the building structure or a material increase in the capacity of the building structure under paragraphs (j)(1)(ii) and (j)(2)(iv) of this section as compared to the condition of the property prior to the deterioration of the insulation. Similarly, the removal and replacement of asbestos is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the property prior to the deterioration of the insulation. Therefore, the amount paid to remove and replace the asbestos insulation is not for a betterment to the building structure or an improvement to the building under paragraph (j) of this section.

Example 3. Not amelioration of pre-existing material condition or defect (i) In January, Year 1, C purchased a used machine for use in its manufacturing operations. Assume that the machine is a unit of property and has a class life of 10 years. C placed the machine in service in January, Year 1 and at that time expected to perform manufacturer recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes cleaning and oiling the machine, inspecting parts for defects, and replacing minor items, such as springs, bearings, and seals, with comparable and commercially available replacement parts. The scheduled maintenance does not include any material additions or materially increase the capacity, productivity, efficiency, strength, quality, or output of the machine. At the time C purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February, Year 1, C pays an amount to perform the manufacturer recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

(ii) The amount that C pays does not qualify under the routine maintenance safe harbor in paragraph (i) of this section, because the cost primarily results from the prior owner's use of the property and not the taxpayer's use. C acquired the machine just before it had received its three-year scheduled maintenance. Accordingly, the amount that C pays for the scheduled maintenance results from the prior owner's use of the property and ameliorates conditions or defects that existed prior to C's ownership of the machine. Nevertheless, considering the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (j)(1)(i) of this section, is not for a material addition to or increase in capacity of the machine under paragraph (j)(1)(ii) of this section, and is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine under paragraph (j)(1)(iii) of this section. Therefore, C is not required to capitalize the amount paid for the scheduled maintenance as a betterment to the unit of property under this paragraph (j).

Example 4. Not amelioration of pre-existing material condition or defect D purchases a used ice resurfacing machine for use in the operation of its ice skating rink. To comply with local regulations, D is required to routinely monitor the air quality in the ice skating rink. One week after D places the machine into service, during a routine air quality check, D discovers that the operation of the machine is adversely affecting the air quality in the skating rink. As a result, D pays an amount to inspect and retune the machine, which includes replacing minor components of the engine that had worn out prior to D's acquisition of the machine. Assume the resurfacing machine, including the engine, is the unit of property. The routine maintenance safe harbor in paragraph (i) of this section does not apply to the amounts paid, because the activities performed do not relate solely to the taxpayer's use of the machine. The amount that D pays to inspect, retune, and replace minor components of the ice resurfacing machine ameliorates a condition or defect that existed prior to D's acquisition of the equipment. Nevertheless, considering the purpose and minor nature of the work performed, this amount does not ameliorate a material condition or defect in the machine under paragraph (j)(1)(i) of this section. In addition, the amount is not paid for a material addition to the machine or a material increase in the capacity of the machine under paragraph (j)(1)(ii) of this section. Also, the activities are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the machine under paragraph (j)(1)(iii) of this section. Therefore, D is not required to capitalize the amount paid to inspect, retune, and replace minor components of the machine as a betterment under this paragraph (j).

Example 5. Amelioration of material condition or defect (i) E acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functions as an assisted living facility. However, at the time of the purchase, E is aware that the building is in a condition that is below the standards that E requires for facilities used in its business. Immediately after the acquisition and during the following two years, while E continues to use the building as an assisted living facility, E pays amounts for extensive repairs and maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which E's facilities are known. The work on E's building includes repairing damaged drywall, repainting, rewallpapering, replacing windows, repairing and replacing doors, replacing and regrouting tile, repairing millwork, and repairing and replacing roofing materials. The work also involves the replacement of section 1245 property, including window treatments, furniture, and cabinets. The work that E performs affects only the building structure under paragraph (e)(2)(ii)(A) of this section and does not affect any of the building systems described in paragraph (e)(2)(ii)(B) of this section. Assume that each section 1245 property is a separate unit of property.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the purpose of the expenditure and the effect of the expenditures on the building structure, the amounts that E paid for repairs and maintenance to the building structure comprise a betterment to the building structure under paragraph (j)(1)(i) of this section because the amounts ameliorate material conditions that existed prior to E's acquisition of the building. Therefore, E must treat the amounts paid for the betterment to the building structure as an improvement to the building and must capitalize the amounts under paragraphs (j) and (d)(1) of this section. Moreover, E is required to capitalize the amounts paid to acquire and install each section 1245 property, including each window treatment, each item of furniture, and each cabinet, in accordance with §1.263(a)–2(d)(1).

Example 6. Not a betterment; building refresh (i) F owns a nationwide chain of retail stores that sell a wide variety of items. To maintain the appearance and functionality of its store buildings after several years of wear, F periodically pays amounts to refresh the look and layout of its stores. The work that F performs during a refresh consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to modernize the store buildings and reorganize the merchandise displays. The work to each store consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing wood flooring throughout the store building, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. F pays amounts to refresh 50 stores during the taxable year. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when F acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the facts and circumstances including the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the buildings' structure and systems, the amounts paid for the refresh of each building are not for any material additions to, or material increases in the capacity of, the buildings' structure or systems as compared with the condition of the structure or systems after the previous refresh. Moreover, the amounts paid are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of any building structure or system under as compared to the condition of the structures or systems after the previous refresh. Rather, the work performed keeps F's store buildings' structures and buildings' systems in their ordinarily efficient operating condition. Therefore, F is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraphs (j)(1)(ii), (j)(1)(iii), and (j)(2)(iv) of this section. However, F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)–2(d)(1).

Example 7. Building refresh; limited improvement (i) Assume the same facts as *Example 6* except, in the course of the refresh to one of its store buildings, F also pays amounts to increase the building's storage space, add a second loading dock, and add a second overhead door. Specifically, at the same time F pays amounts to perform the refresh, F pays additional amounts to construct an addition to the back of the store building, including adding a new overhead door and loading dock to the building. The work also involves upgrades to the electrical system of the building, including the addition of a second service box with increased amperage and new wiring from the service box to provide lighting and power throughout the new space. Although it is performed at the same time, the construction of the additions does not affect, and is not otherwise related to, the refresh of the retail space.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Under paragraph (j)(1)(ii) of this section, the amounts paid by F to add the storage space, loading dock, overhead door, and expand the electrical system are for betterments to F's building structure and to the electrical system because they are for material additions to, and a material increase in capacity of, the structure and the electrical system of F's store building. Accordingly, F must treat the amounts paid for these betterments as improvements to the building unit of property and capitalize these amounts under paragraphs (d)(1) and (j) of this section. However, for the reasons discussed in *Example 6*, F is not required to treat the amounts paid for the refresh of its store building structure and systems as a betterments under paragraph (j)(1) of this section. In addition, F is not required under paragraph (g)(1) of this section to capitalize the refresh costs described in *Example 6* because these costs do not directly benefit and are not incurred by reason of the additions to the building structure and electrical system. As in *Example 6*, F is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)–2(d)(1).

Example 8. Betterment; building remodel (i) G owns a large chain of retail stores that sell a variety of items. G determines that due to changes in the retail market, it can no longer compete in its current store class and decides to upgrade its stores to offer higher end products to a different type of customer. To offer these products and attract different types of customers, G must substantially remodel its stores. Thus, G pays amounts to remodel its stores by performing work on the buildings' structures and systems as defined under paragraphs (e)(2)(ii)(A) and (e)(2)(ii)(B) of this section. This work includes replacing large parts of the exterior walls with windows, replacing the escalators with a monumental staircase, adding a new glass enclosed elevator, rebuilding the interior and exterior facades, replacing vinyl floors with ceramic flooring, replacing ceiling tiles with acoustical tiles, and removing and rebuilding walls to move changing rooms and create specialty departments. The work also includes upgrades to increase the capacity of the buildings' electrical system to accommodate the structural changes and the addition of new section 1245 property, such as new product information kiosks and point of sale systems. The work to the electrical system also involves the installation of new more efficient and mood enhancing lighting fixtures. In addition, the work includes remodeling all bathrooms by replacing contractor-grade plumbing fixtures with designer-grade fixtures that conserve water and energy. Finally, G also pays amounts to clean debris resulting from construction during the remodel, patch holes in walls that were made to upgrade the electrical system, repaint existing walls with a new color scheme to match the new interior construction, and to power wash building exteriors to enhance the new exterior facade.

(ii) Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. Considering the facts and circumstances, including the purpose of the expenditure, the physical nature of the work performed, and the effect of the work on the buildings' structures and buildings' systems, the amounts that G pays for the remodeling of its stores result in betterments to the buildings' structures and several of its systems under paragraph (j) of this section. Specifically, the amounts paid to replace large parts of the exterior walls with windows, replace the escalators with a monumental staircase, add a new elevator, rebuild the interior and exterior facades, replace vinyl floors with ceramic flooring, replace the ceiling tiles with acoustical tiles, and to remove and rebuild walls are for material additions, that is the addition of major components, to the building structure under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of the building structure under paragraph (j)(1)(iii) of this section. Similarly, the amounts paid to upgrade the electrical system are to materially increase the capacity of the electrical system under paragraph (j)(1)(ii) of this section and are reasonably expected to increase the quality of this system under paragraph (j)(1)(iii) of this section. In addition, the amounts paid to remodel the bathrooms with higher grade and more resource-efficient materials are reasonably expected to increase the efficiency and quality of the plumbing system under paragraph (j)(1)(iii) of this section. Finally, the amounts paid to clean debris, patch and repaint existing walls with a new color scheme, and to power wash building exteriors, while not betterments by themselves, directly benefitted and were incurred by reason of the improvements to G's store buildings' structures and electrical systems under paragraph (g)(1) of this section. Therefore, G must treat the amounts paid for betterments to the store buildings' structures and systems, including the costs of cleaning, patching, repairing, and power washing the building, as improvements to G's buildings and must capitalize these amounts under paragraphs (d)(1) and (j) of this section. Moreover, G is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with §1.263(a)–2(d)(1). For the treatment of amounts paid to remove components of property, see paragraph (g)(2) of this section.

Example 9. Not betterment; relocation and reinstallation of personal property In Year 1, H purchases new cash registers for use in its retail store located in leased space in a shopping mall. Assume that each cash register is a unit of property as determined under paragraph (e)(3) of this section. In Year 1, H capitalizes the costs of acquiring and installing the new cash registers under §1.263(a)–2(d)(1). In Year 3, H's lease expires, and H decides to relocate its retail store to a different building. In addition to various other costs, H pays $5,000 to move the cash registers and $1,000 to reinstall them in the new store. The cash registers are used for the same purpose and in the same manner that they were used in the former location. The amounts that H pays to move and reinstall the cash registers into its new store do not result in a betterment to the cash registers under paragraph (j) of this section.

Example 10. Betterment; relocation and reinstallation of equipment J operates a manufacturing facility in Building A, which contains various machines that J uses in its manufacturing business. J decides to expand part of its operations by relocating a machine to Building B to reconfigure the machine with additional components. Assume that the machine is a single unit of property under paragraph (e)(3) of this section. J pays amounts to disassemble the machine, to move the machine to the new location, and to reinstall the machine in a new configuration with additional components. Assume that the reinstallation, including the reconfiguration and the addition of components, is for an increase in capacity of the machine, and therefore is for a betterment to the machine under paragraph (j)(1)(ii) of this section. Accordingly, J must capitalize the costs of reinstalling the machine as an improvement to the machine under paragraphs (j) and (d)(1) of this section. J is also required to capitalize the costs of disassembling and moving the machine to Building B because these costs directly benefit and are incurred by reason of the improvement to the machine under paragraph (g)(1) of this section.

Example 11. Betterment; regulatory requirement K owns a building that it uses in its business. In Year 1, City C passes an ordinance setting higher safety standards for buildings because of the hazardous conditions caused by earthquakes. To comply with the ordinance, K pays an amount to add expansion bolts to its building structure. These bolts anchor the wooden framing of K's building to its cement foundation, providing additional structural support and resistance to seismic forces, making the building more resistant to damage from lateral movement. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The framing and foundation are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. Prior to the ordinance, the old building was in good condition but did not meet City C's new requirements for earthquake resistance. The amount paid by K for the addition of the expansion bolts met City C's new requirement, but also materially increased the strength of the building structure under paragraph (j)(1)(iii) of this section. Therefore, K must treat the amount paid to add the expansion bolts as a betterment to the building structure and must capitalize this amount as an improvement to building under paragraphs (d)(1) and (j) of this section. Under paragraph (g)(4) of this section, City C's new requirement that K's building meet certain safety standards to continue to operate is not relevant in determining whether the amount paid improved the building.

Example 12. Not a betterment; regulatory requirement L owns a meat processing plant. After operating the plant for many years, L discovers that oil is seeping through the concrete walls of the plant. Federal inspectors advise L that it must correct the seepage problem or shut down its plant. To correct the problem, L pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The walls are part of the building structure as defined in paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the seepage of the oil into the plant. Prior to the seepage, the walls did not leak and were functioning for their intended use. L is not required to treat the amount paid as a betterment under paragraphs (j)(1)(ii) and (j)(2)(iv) of this section because it is not paid for a material addition to, or a material increase in the capacity of, the building's structure as compared to the condition of the structure prior to the seepage of oil. Moreover, the amount paid is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraphs (j)(1)(iii) and (j)(2)(iv) as compared to the condition of the structure prior to the seepage of the oil Therefore, L is not required to treat the amount paid to correct the seepage as a betterment to the building under paragraph (d)(1) or (j) of this section. The federal inspectors' requirement that L correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant.

Example 13. Not a betterment; new roof membrane M owns a building that it uses for its retail business. Over time, the waterproof membrane (top layer) on the roof of M's building begins to wear, and M began to experience water seepage and leaks throughout its retail premises. To eliminate the problems, a contractor recommends that M put a new rubber membrane on the worn membrane. Accordingly, M pays the contractor to add the new membrane. The new membrane is comparable to the worn membrane when it was originally placed in service by the taxpayer. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The roof is part of the building structure under paragraph (e)(2)(ii)(A) of this section. The condition necessitating the expenditure was the normal wear of M's roof. Under paragraph (j)(2)(iv) of this section, to determine whether the amounts are for a betterment, the condition of the building structure after the expenditure must be compared to the condition of the structure when M placed the building into service because M has not previously corrected the effects of normal wear and tear. Under these facts, the amount paid to add the new membrane to the roof is not for a material addition or a material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section as compared to the condition of the structure when it was placed in service. Moreover, the new membrane is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure under paragraph (j)(1)(iii) of this section as compared to the condition of the building structure when it was placed in service. Therefore, M is not required to treat the amount paid to add the new membrane as a betterment to the building under paragraph (d)(1) or (j) of this section.

Example 14. Material increase in capacity; building N owns a factory building with a storage area on the second floor. N pays an amount to reinforce the columns and girders supporting the second floor to permit storage of supplies with a gross weight 50 percent greater than the previous load-carrying capacity of the storage area. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The columns and girders are part of the building structure defined under paragraph (e)(2)(ii)(A) of this section. N must treat the amount paid to reinforce the columns and girders as a betterment under paragraphs (j)(1)(ii) and (j)(1)(iii) of this section because it materially increases the load-carrying capacity and the strength of the building structure. Therefore, N must capitalize this amount as an improvement to the building under paragraphs (d)(1) and (j) of this section.

Example 15. Material increase in capacity; channel O owns harbor facilities consisting of a slip for the loading and unloading of barges and a channel leading from the slip to the river. At the time of purchase, the channel was 150 feet wide, 1,000 feet long, and 10 feet deep. Several years after purchasing the harbor facilities, to allow for ingress and egress and for the unloading of larger barges, O decides to deepen the channel to a depth of 20 feet. O pays a contractor to dredge the channel to 20 feet. Assume the channel is the unit of property. O must capitalize the amounts paid for the dredging as an improvement to the channel because they are for a material increase in the capacity of the unit of property under paragraph (j)(1)(ii) of this section.

Example 16. Not a material increase in capacity; channel Assume the same facts as in *Example 15*, except that the channel was susceptible to siltation and, after dredging to 20 feet, the channel depth had been reduced to 18 feet. O pays a contractor to redredge the channel to a depth of 20 feet. The expenditure was necessitated by the siltation of the channel. Both prior to the siltation and after the redredging, the depth of the channel was 20 feet. Applying the comparison rule under paragraph (j)(2)(iv) of this section, the amounts paid by O to redredge the channel are not for a betterment under paragraph (j)(1)(ii) of this section because they are not for a material addition to, or a material increase in the capacity of, the unit of property as compared to the condition of the property prior to the siltation. Similarly, these amounts are not for a betterment under paragraph (j)(1)(iii) of this section because the amounts are not reasonably expected to increase the productivity, efficiency, strength, quality, or output of the unit of property as compared to the condition of the property before the siltation. Therefore, O is not required to capitalize these amounts as improvement under paragraphs (d)(1) and (j) of this section.

Example 17. Material increase in capacity; channel Assume the same facts as in *Example 16* except that after the redredging, there is more siltation, and the channel depth is reduced back to 18 feet. In addition, to allow for additional ingress and egress and for the unloading of even larger barges, O decides to deepen the channel to a depth of 25 feet. O pays a contractor to redredge the channel to 25 feet. O must capitalize the amounts paid for the dredging as an improvement to the channel because the amounts are for a material increase in the capacity of the unit of property under paragraph (j)(1)(ii) of this section as compared to condition of the unit of property before the siltation. As part of this improvement, O is also required to capitalize the portion of the redredge costs allocable to restoring the depth lost to the siltation because, under paragraph (g)(1)(i) of this section, these amounts directly benefit and are incurred by reason of the improvement to the unit of property.

Example 18. Not a material increase in capacity; building P owns a building used in its trade or business. The first floor has a drop-ceiling. To fully expose windows on the first floor, P pays an amount to remove the drop-ceiling and repaint the original ceiling. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The ceiling is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. P is not required to treat the amount paid to remove the drop-ceiling as a betterment to the building because it was not for a material addition or material increase in the capacity of the building structure under paragraph (j)(1)(ii) of this section and it was not reasonably expected to materially increase to the efficiency, strength, or quality of the building structure under paragraph (j)(1)(iii) of this section. In addition, under paragraph (j)(2)(i) of this section, because the effect on productivity and output of the building structure cannot be measured in this context, these factors are not relevant in determining whether there is a betterment to the building structure.

Example 19. Material increase in capacity; building Q owns a building that it uses in its retail business. The building contains one floor of retail space with very high ceilings. Q pays an amount to add a stairway and a mezzanine for the purposes of adding additional selling space within its building. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The stairway and the mezzanine are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Q is required to treat the amount paid to add the stairway and mezzanine as a betterment because it is for a material addition to, and an increase in the capacity of, the building structure under paragraph (j)(1)(ii) of this section. Therefore, Q must capitalize this amount as an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section.

Example 20. Not material increase in efficiency; HVAC system R owns an office building that it uses to provide services to customers. The building contains an HVAC system that incorporates 10 roof-mounted units that provide heating and air conditioning for different parts of the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. After many years of use of the HVAC system, R begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that R replace two of the roof-mounted units. R pays an amount to replace the two specified units. The two new units are expected to eliminate the climate control problems and to be 10 percent more energy efficient than the replaced units in their original condition. No work is performed on the other roof-mounted heating/cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The HVAC system, including the two-roof mounted units, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The replacement of the two roof-mounted units is not a material addition to or a material increase in the capacity of the HVAC system under paragraphs (j)(1)(ii) and (j)(3)(ii) of this section as compared to the condition of the system prior to the climate control problems. In addition, given the 10 percent efficiency increase in two units of the entire HVAC system, the replacement is not expected to materially increase the productivity, efficiency, strength, quality, or output of the HVAC system under paragraphs (j)(1)(iii) and (j)(2)(iv) of this section as compared to the condition of the system prior to the climate control problems. Therefore, R is not required to capitalize the amounts paid for these replacements as betterments to the building unit of property under paragraphs (d)(1) and (j) of this section.

Example 21. Material increase in efficiency; building S owns a building that it uses in its service business. S conducts an energy assessment and determines that it could significantly reduce its energy costs by adding insulation to its building. S pays an insulation contractor to apply a combination of loose-fill, spray foam, and blanket insulation throughout S's building structure, including within the attic, walls, and crawl spaces. S reasonably expects the new insulation to make the building more energy efficient because the contractor indicated that the new insulation would reduce its annual energy and power costs by approximately 50 percent of its annual costs during the last five years. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building if the amount is paid for a betterment to the building structure or any building system. Therefore, under paragraphs (d)(1) and (j) of this section, S must capitalize as a betterment the amount paid to add the insulation because the insulation is reasonably expected to materially increase the efficiency of the building structure under paragraph (j)(1)(iii) of this section.

Example 22. Material addition; building T owns and operates a restaurant, which provides a variety of prepared foods to its customers. To better accommodate its customers and increase customer traffic, T decides to add a drive-through service area. As a result, T pays amounts to partition an area within its restaurant for a drive-through service counter, to construct a service window with necessary security features, to build an overhang for vehicles, and to construct a drive-up menu board. Assume that the drive-up menu board is section 1245 property that is a separate unit of property under paragraph (e)(3) of this section. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The amounts paid for the partition, service window and overhang are betterments to the building structure because they comprise a material addition (that is, a physical expansion, extension, and addition of a major component) to the building structure under paragraph (j)(1)(ii) of this section. Accordingly, T must capitalize as an improvement the amounts paid to add the partition, drive-through window, and overhang under paragraphs (d)(1) and (j) of this section. T is also required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)–2(d)(1).

Example 23. Costs incurred during betterment U owns a building that it uses in its service business. To accommodate new employees and equipment, U pays amounts to increase the load capacity of its electrical system by adding a second electrical panel with additional circuits and adding wiring and outlets throughout the electrical system of its building. To complete the upgrades to the electrical system, the contractor makes several holes in walls. As a result, U also incurs costs to patch the holes and repaint several walls. Under paragraphs (e)(2)(ii) and (j)(2)(ii) of this section, an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The amounts paid to upgrade the panel and wiring are for betterments to U's electrical system because they increase the capacity of the electrical system under paragraph (j)(1)(ii) of this section and increase the strength and output of the electrical system under paragraph (j)(1)(iii) of this section. Accordingly, U is required to capitalize the costs of the upgrade to the electrical system as an improvement to the building unit of property under paragraphs (d)(1) and (j) of this section. Moreover, under paragraph (g)(1) of this section, U is required to capitalize the amounts paid to patch holes and repaint several walls in its building because these costs directly benefit and are incurred by reason of the improvement to U's building unit of property.

(k) *Capitalization of restorations*—(1) *In general.* A taxpayer must capitalize as an improvement an amount paid to restore a unit of property, including an amount paid to make good the exhaustion for which an allowance is or has been made. An amount restores a unit of property only if it—

(i) Is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component, other than a casualty loss under § 1.165–7;

(ii) Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;

(iii) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss under section 165, or relating to a casualty event described in section 165, subject to the limitation in paragraph (k)(4) of this section;

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

(v) Results in the rebuilding of the unit of property to a like-new condition as determined under paragraph (k)(5) of this section after the end of its class life as defined in paragraph (i)(4) of this section; or

(vi) Is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property as determined under paragraph (k)(6) of this section.

(2) *Application of restorations to buildings.* An amount is paid to improve a building if it is paid to restore, as defined under paragraph (k)(1) of this section, a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or portion of building) of this section. For example, an amount is paid to improve a building if it is paid for the replacement of a part or combination of parts that comprise a major component or substantial structural part of the building structure or any one of its building systems (for example, the HVAC system). See paragraph (k)(6) of this section.

(3) *Exception for losses based on salvage value.* A taxpayer is not required to treat as a restoration amounts paid under paragraph (k)(1)(i) or paragraph (k)(1)(ii) of this section if the unit of property has been fully depreciated and the loss is attributable only to remaining salvage value as computed for federal income tax purposes.

(4) *Restoration of damage from casualty*—(i) *Limitation.* For purposes of paragraph (k)(1)(iii) of this section, the amount paid for restoration of damage to the unit of property that must be capitalized under this paragraph (k) is limited to the excess (if any) of—

(A) The amount prescribed by § 1.1011–1 as the adjusted basis of the single, identifiable property (under § 1.167–7(b)(2)(i)) for determining the loss allowable on account of the casualty, over

(B) The amount paid for restoration of damage to the unit of property under paragraph (k)(1)(iii) of this section that also constitutes an improvement under any other provision of paragraph (k)(1) of this section.

(ii) *Amounts in excess of limitation.* The amounts paid for restoration of damage to a unit of property as described in paragraph (k)(1)(iii) of this section, but that exceed the limitation provided in paragraph (k)(4)(i) of this section, must be treated in accordance with the provisions of the Internal Revenue Code and regulations that are otherwise applicable. See, for example, §1.162–4 (repairs and maintenance); §1.263(a)–2 (costs to acquire and produce units of property); and §1.263(a)-3 (costs to improve units of property).

(5) *Rebuild to like-new condition.* For purposes of paragraph (k)(1)(v) of this section, a unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or a similar status under the terms of any federal regulatory guideline or the manufacturer's original specifications. Generally, a comprehensive maintenance program, even though substantial, does not return a unit of property to a like-new condition.

(6) *Replacement of a major component or a substantial structural part*—(i) *In general.* To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property under paragraph (k)(1)(vi) of this section, it is appropriate to consider all the facts and circumstances. These facts and circumstances include the quantitative and qualitative significance of the part or combination of parts in relation to the unit of property.

(A) *Major component.* A major component is a part or combination of parts that performs a discrete and critical function in the operation of the unit of property. An incidental component of the unit of property, even though such component performs a discrete and critical function in the operation of the unit of property, generally will not, by itself, constitute a major component.

(B) *Substantial structural part.* A substantial structural part is a part or combination of parts that comprises a large portion of the physical structure of the unit of property.

(ii) *Major components and substantial structural parts of buildings.* In the case of a building, an amount is for the replacement of a major component or a substantial structural part of the building unit of property if—

(A) The replacement includes a part or combination of parts that comprise a major component (as defined in paragraph (k)(6)(i)(A) of this section), or a significant portion of a major component, of any of the properties designated in paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of a building) of this section; or

(B) The replacement includes a part or combination of parts that comprises a large portion of the physical structure of any of the properties designated in paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or portion of building) of this section.

(7) *Examples.* The following examples illustrate the application of this paragraph (k) only and do not address whether capitalization is required under another provision of this section or another provision of the Code (for example, section 263A). Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for, nor taken into account the adjusted basis on a sale or exchange of, any unit of property, asset, or component of a unit of property that is replaced.

Example 1. Replacement of loss component A owns a manufacturing building containing various types of manufacturing equipment. A does a cost segregation study of the manufacturing building and properly determines that a walk-in freezer in the manufacturing building is section 1245 property as defined in section 1245(a)(3). The freezer is not part of the building structure or the HVAC system under paragraph (e)(2)(i) or (e)(2)(ii)(B)(*1*) of this section. Several components of the walk-in freezer cease to function, and A decides to replace them. A abandons the old freezer components and properly recognizes a loss from the abandonment of the components. A replaces the abandoned freezer components with new components and incurs costs to acquire and install the new components. Under paragraph (k)(1)(i) of this section, A must capitalize the amounts paid to acquire and install the new freezer components because A replaced components for which it had properly deducted a loss.

Example 2. Replacement of sold component Assume the same facts as in *Example 1*, except that A did not abandon the components but instead sold them to another party and properly recognized a loss on the sale. Under paragraph (k)(1)(ii) of this section, A must capitalize the amounts paid to acquire and install the new freezer components because A replaced components for which it had properly taken into account the adjusted basis of the components in realizing a loss from the sale of the components.

Example 3. Restoration after casualty loss B owns an office building that it uses in its trade or business. A storm damages the office building at a time when the building has an adjusted basis of $500,000. B deducts under section 165 a casualty loss in the amount of $50,000, and properly reduces its basis in the office building to $450,000. B hires a contractor to repair the damage to the building, including the repair of the building roof and the removal of debris from the building premises. B pays the contractor $50,000 for the work. Under paragraph (k)(1)(iii) of this section, B must treat the $50,000 amount paid to the contractor as a restoration of the building structure because B properly adjusted its basis in that amount as a result of a casualty loss under section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

Example 4. Restoration after casualty event Assume the same facts as in *Example 3*, except that B receives insurance proceeds of $50,000 after the casualty to compensate for its loss. B cannot deduct a casualty loss under section 165 because its loss was compensated by insurance. However, B properly reduces its basis in the property by the amount of the insurance proceeds. Under paragraph (k)(1)(iii) of this section, B must treat the $50,000 amount paid to the contractor as a restoration of the building structure because B has properly taken a basis adjustment relating to a casualty event described in section 165, and the amount does not exceed the limit in paragraph (k)(4) of this section. Therefore, B must treat the amount paid as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

Example 5. Restoration after casualty loss; limitation (i) C owns a building that it uses in its trade or business. A storm damages the building at a time when the building has an adjusted basis of $500,000. C determines that the cost of restoring its property is $750,000, deducts a casualty loss under section 165 in the amount of $500,000, and properly reduces its basis in the building to $0. C hires a contractor to repair the damage to the building and pays the contractor $750,000 for the work. The work involves replacing the entire roof structure of the building at a cost of $350,000 and pumping water from the building, cleaning debris from the interior and exterior, and replacing areas of damaged dry wall and flooring at a cost of $400,000. Although resulting from the casualty event, the pumping, cleaning, and replacing damaged drywall and flooring, does not directly benefit and is not incurred by reason of the roof replacement.

(ii) Under paragraph (k)(1)(vi) of this section, C must capitalize as an improvement the $350,000 amount paid to the contractor to replace the roof structure because the roof structure constitutes a major component and a substantial structural part of the building unit of property. In addition, under paragraphs (k)(1)(iii) and (k)(4)(i), C must treat as a restoration the remaining costs, limited to the excess of the adjusted basis of the building over the amounts paid for the improvement under paragraph (k)(1)(vi). Accordingly, C must treat as a restoration $150,000 ($500,000—$350,000) of the $400,000 paid for the portion of the costs related to repairing and cleaning the building structure under paragraph (k)(1)(iii) of this section. Thus, in addition to the $350,000 to replace the roof structure, C must also capitalize the $150,000 as an improvement to the building unit of property under paragraph (d)(2) of this section. C is not required to capitalize the remaining $250,000 repair and cleaning costs under paragraph (k)(1)(iii) of this section.

Example 6. Restoration of property in a state of disrepair D owns and operates a farm with several barns and outbuildings. D did not use or maintain one of the outbuildings on a regular basis, and the outbuilding fell into a state of disrepair. The outbuilding previously was used for storage but can no longer be used for that purpose because the building is not structurally sound. D decides to restore the outbuilding and pays an amount to shore up the walls and replace the siding. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The walls and siding are part of the building structure under paragraph (e)(2)(ii)(A) of this section. Under paragraph (k)(1)(iv) of this section, D must treat the amount paid to shore up the walls and replace the siding as a restoration of the building structure because the amounts return the building structure to its ordinarily efficient operating condition after it had deteriorated to a state of disrepair and was no longer functional for its intended use. Therefore, D must treat the amount paid to shore up the walls and replace the siding as an improvement to the building unit of property and, under paragraph (d)(2) of this section, must capitalize the amount paid.

Example 7. Rebuild of property to like-new condition before end of class life E is a Class I railroad that owns a fleet of freight cars. Assume the freight cars have a recovery period of 7 years under section 168(c) and a class life of 14 years. Every 8 to 10 years, E rebuilds its freight cars. Ten years after E places the freight car in service, E performs a rebuild to the manufacturer's original specification, which includes a complete disassembly, inspection, and reconditioning or replacement of components of the suspension and draft systems, trailer hitches, and other special equipment. E also modifies the car to upgrade various components to the latest engineering standards. The freight car is stripped to the frame, with all of its substantial components either reconditioned or replaced. The frame itself is the longest-lasting part of the car and is reconditioned. The walls of the freight car are replaced or are sandblasted and repainted. New wheels are installed on the car. All the remaining components of the car are restored before they are reassembled. At the end of the rebuild, the freight car has been restored to like-new condition under the manufacturer's specifications. Assume the freight car is the unit of property. E is not required to treat as an improvement and capitalize the amounts paid to rebuild the freight car under paragraph (k)(1)(v) of this section because, although the amounts paid restore the freight car to like-new condition, the amounts were not paid after the end of the class life of the freight car. However, paragraphs (k)(1)(vi) and (k)(6) of this section are applicable for determining whether any amounts must be capitalized because they are paid for the replacement of a major component or a substantial structural part of the unit of property.

Example 8. Rebuild of property to like-new condition after end of class life Assume the same facts as in *Example 7*, except that E rebuilds the freight car 15 years after E places it in service. Under paragraph (k)(1)(v) of this section, E must treat as an improvement and capitalize the amounts paid to rebuild the freight car because the amounts paid restore the freight car to like-new condition after the end of the class life of the freight car.

Example 9. Not a rebuild to a like-new condition F is a commercial airline engaged in the business of transporting freight and passengers. To conduct its business, F owns several aircraft. As a condition of maintaining its airworthiness certificates, F is required by the FAA to establish and adhere to a continuous maintenance program for each aircraft in its fleet. F performs heavy maintenance on its airframes every 8 to 10 years. In Year 1, F purchased an aircraft for $15 million. In Year 16, F paid $2 million for the labor and materials necessary to perform the second heavy maintenance visit on the airframe of an aircraft. To perform the heavy maintenance visit, F extensively disassembles the airframe, removing items such as engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. As specified by F's maintenance manual for the aircraft, F then performs certain tasks on the disassembled airframe for the purpose of preventing deterioration of the inherent safety and reliability levels of the airframe. These tasks include lubrication and service, operational and visual checks, inspection and functional checks, reconditioning of minor parts and components, and removal, discard, and replacement of certain life-limited single cell parts, such as cartridges, canisters, cylinders, and disks. Reconditioning of parts includes burnishing corrosion, repairing cracks, dents, gouges, punctures, tightening or replacing loose or missing fasteners, replacing damaged seals, gaskets, or valves, and similar activities. In addition to the tasks described above, to comply with certain FAA airworthiness directives, F inspects specific skin locations, applies doublers over small areas where cracks were found, adds structural reinforcements, and replaces skin panels on a small section of the fuselage. However, the heavy maintenance does not include the replacement of any major components or substantial structural parts of the aircraft with new components. In addition, the heavy maintenance visit does not bring the aircraft to the status of new, rebuilt, remanufactured, or a similar status under FAA guidelines or the manufacturer's original specifications. After the heavy maintenance, the aircraft was reassembled. Assume the aircraft, including the engines, is a unit of property and has a class life of 12 years under section 168(c). Although the heavy maintenance is performed after the end of the class life of the aircraft, F is not required to treat the heavy maintenance as a restoration and improvement of the unit of property under paragraph (k)(1)(v) of this section because, although extensive, the amounts paid do not restore the aircraft to like-new condition. See also paragraph (i)(1)(iii) of this section for the application of the safe harbor for routine maintenance.

Example 10. Replacement of major component or substantial structural part; personal property

≤ G is a common carrier that owns a fleet of petroleum hauling trucks. G pays amounts to replace the existing engine, cab, and petroleum tank with a new engine, cab, and tank. Assume the tractor of the truck (which includes the cab and the engine) is a single unit of property and that the trailer (which contains the petroleum tank) is a separate unit of property. The new engine and the cab each constitute a part or combination of parts that comprise a major component of G's tractor, because they perform a discrete and critical function in the operation of the tractor. In addition, the cab constitutes a part or combination of parts that comprise a substantial structural part of G's tractor. Therefore, the amounts paid for the replacement of the engine and the cab must be capitalized under paragraph (k)(1)(vi) of this section. Moreover, the new petroleum tank constitutes a part or combination of parts that comprise a major component and a substantial structural part of the trailer. Accordingly, the amounts paid for the replacement of the tank also must be capitalized under paragraph (k)(1)(vi) of this section.

Example 11. Repair performed during restoration Assume the same facts as in *Example 10*, except that, at the same time the engine and cab of the tractor are replaced, G pays amounts to paint the cab of the tractor with its company logo and to fix a broken taillight on the tractor. The repair of the broken taillight and the painting of the cab generally are deductible expenses under § 1.162–4. However, under paragraph (g)(1)(i) of this section, a taxpayer must capitalize all the direct costs of an improvement and all the indirect costs that directly benefit or are incurred by reason of an improvement. Repairs and maintenance that do not directly benefit or are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether they are made at the same time as an improvement. For the amounts paid to paint the logo on the cab, G's need to paint the logo arose from the replacement of the cab with a new cab. Therefore, under paragraph (g)(1)(i) of this section, G must capitalize the amounts paid to paint the cab as part of the improvement to the tractor because these amounts directly benefit and are incurred by reason of the restoration of the tractor. The amounts paid to repair the broken taillight are not for the replacement of a major component, do not directly benefit, and are not incurred by reason of the replacement of the cab or the engine under paragraph (g)(1)(i) of this section, even though the repair was performed at the same time as these replacements. Thus, G is not required to capitalize the amounts paid to repair the broken taillight.

Example 12. Related amounts to replace major component or substantial structural part; personal property (i) H owns a retail gasoline station, consisting of a paved area used for automobile access to the pumps and parking areas, a building used to market gasoline, and a canopy covering the gasoline pumps. The premises also consist of underground storage tanks (USTs) that are connected by piping to the pumps and are part of the gasoline pumping system used in the immediate retail sale of gas. The USTs are components of the gasoline pumping system. To comply with regulations issued by the Environmental Protection Agency, H is required to remove and replace leaking USTs. In Year 1, H hires a contractor to perform the removal and replacement, which consists of removing the old tanks and installing new tanks with leak detection systems. The removal of the old tanks includes removing the paving material covering the tanks, excavating a hole large enough to gain access to the old tanks, disconnecting any strapping and pipe connections to the old tanks, and lifting the old tanks out of the hole. Installation of the new tanks includes placement of a liner in the excavated hole, placement of the new tanks, installation of a leak detection system, installation of an overfill system, connection of the tanks to the pipes leading to the pumps, backfilling of the hole, and replacement of the paving. H also is required to pay a permit fee to the county to undertake the installation of the new tanks.

(ii) H pays the permit fee to the county on October 15, Year 1. On December 15, Year 1, the contractor completes the removal of the old USTs and bills H for the costs of removal. On January 15, Year 2, the contractor completes the installation of the new USTs and bills H for the remainder of the work. Assume that H computes its taxes on a calendar year basis and H's gasoline pumping system is the unit of property. Under paragraph (k)(1)(vi) of this section, H must capitalize the amounts paid to replace the USTs as a restoration to the gasoline pumping system because the USTs are parts or combinations of parts that comprise a major component and substantial structural part of the gasoline pumping system. Moreover, under paragraph (g)(2) of this section, H must capitalize the costs of removing the old USTs because H has not taken a loss on the disposition of the USTs, and the amounts to remove the USTs directly benefit and are incurred by reason of the restoration of, and improvement to, the gasoline pumping system. In addition, under paragraph (g)(1) of this section, H must capitalize the permit fees because they directly benefit and are incurred by reason of the improvement to the gasoline pumping system. Finally, under paragraph (g)(3) of this section, H must capitalize the related amounts paid to improve the gasoline pumping system, including the permit fees, the amount paid to remove the old USTs, and the amount paid to install the new USTs, even though the amounts were separately invoiced, paid to different parties, and incurred in different tax years.

Example 13. Not replacement of major component; incidental J owns a machine shop in which it makes dies used by manufacturers. In Year 1, J purchased a drill press for use in its production process. In Year 3, J discovers that the power switch assembly, which controls the supply of electric power to the drill press, has become damaged and cannot operate. To correct this problem, J pays amounts to replace the power switch assembly with comparable and commercially available replacement parts. Assume that the drill press is a unit of property under paragraph (e) of this section and the power switch assembly is a small component of the drill press that may be removed and installed with relative ease. The power switch assembly is not a major component of the unit of property under paragraph (k)(6)(i)(A) of this section because, although the power assembly may affect the function of J's drill press by controlling the supply of electric power, the power assembly is an incidental component of the drill press. In addition, the power assembly is not a substantial structural part of J's drill press under paragraph (k)(6)(i)(B) of this section. Therefore, J is not required to capitalize the costs to replace the power switch assembly under paragraph (k)(1)(vi) of this section.

Example 14. Replacement of major component or substantial structural part; roof K owns a manufacturing building. K discovers several leaks in the roof of the building and hires a contractor to inspect and fix the roof. The contractor discovers that a major portion of the decking has rotted and recommends the replacement of the entire roof. K pays the contractor to replace the entire roof, including the decking, insulation, asphalt, and various coatings. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The roof is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure under paragraph (k)(6)(ii)(A) of this section. In addition, because the roof comprises a large portion of the physical structure of the building structure, the roof comprises a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under either analysis, K must treat the amount paid to replace the roof as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement under paragraph (d)(2) of this section.

Example 15. Not replacement of major component or substantial structural part; roof membrane L owns a building in which it conducts its retail business. The roof decking over L's building is covered with a waterproof rubber membrane. Over time, the rubber membrane begins to wear, and L begins to experience leaks into its retail premises. However, the building is still functioning in L's business. To eliminate the problems, a contractor recommends that L replace the membrane on the roof with a new rubber membrane. Accordingly, L pays the contractor to strip the original membrane and replace it with a new rubber membrane. The new membrane is comparable to the original membrane but corrects the leakage problems. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The roof, including the membrane, is part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. Because the entire roof performs a discrete and critical function in the building structure, the roof comprises a major component of the building structure under paragraph (k)(6)(ii)(A) of this section. Although the replacement membrane may aid in the function of the building structure, it does not, by itself, comprise a significant portion of the roof major component under paragraph (k)(6)(ii)(A) of this section. In addition, the replacement membrane does not comprise a substantial structural part of L's building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, L is not required to capitalize the amount paid to replace the membrane as a restoration of the building under paragraph (k)(1)(vi) of this section.

Example 16. Not a replacement of major component or substantial structural part; HVAC system M owns a building in which it operates an office that provides medical services. The building contains one HVAC system, which is comprised of three furnaces, three air conditioning units, and duct work that runs throughout the building to distribute the hot or cold air throughout the building. One furnace in M's building breaks down, and M pays an amount to replace it with a new furnace. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the furnaces, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. As the parts that provide the heating function in the system, the three furnaces, together, perform a discrete and critical function in the operation of the HVAC system and are therefore a major component of the HVAC system under paragraph (k)(6)(i)(A) of this section. However, the single furnace is not a significant portion of this major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system under paragraph (k)(6)(ii)(B) of this section. Therefore, M is not required to treat the amount paid to replace the furnace as a restoration of the building under paragraph (k)(1)(vi) of this section.

Example 17. Replacement of major component or substantial structural part; HVAC system N owns a large office building in which it provides consulting services. The building contains one HVAC system, which is comprised of one chiller unit, one boiler, pumps, duct work, diffusers, air handlers, outside air intake, and a cooling tower. The chiller unit includes the compressor, evaporator, condenser, and expansion valve, and it functions to cool the water used to generate air conditioning throughout the building. N pays an amount to replace the chiller with a comparable unit. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount is paid to restore the building structure or any building system. The HVAC system, including the chiller unit, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. The chiller unit performs a discrete and critical function in the operation of the HVAC system because it provides the cooling mechanism for the entire system. Therefore, the chiller unit is a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. Because the chiller unit comprises a major component of a building system, N must treat the amount paid to replace the chiller unit as a restoration to the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 18. Not replacement of major component or substantial structural part; HVAC system O owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for the building. The HVAC system also consists of controls for the entire system and duct work that distributes the heated or cooled air to the various spaces in the building's interior. O begins to experience climate control problems in various offices throughout the office building and consults with a contractor to determine the cause. The contractor recommends that O replace three of the roof-mounted heating and cooling units. O pays an amount to replace the three specified units. No work is performed on the other roof-mounted heating and cooling units, the duct work, or the controls. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The HVAC system, including the 10 roof-mounted heating and cooling units, is a building system under paragraph (e)(2)(ii)(B)(*1*) of this section. As the components that generate the heat and the air conditioning in the HVAC system, the 10 roof-mounted units, together, perform a discrete and critical function in the operation of the HVAC system and, therefore, are a major component of the HVAC system under paragraph (k)(6)(ii)(A) of this section. The three roof-mounted heating and cooling units are not a significant portion of a major component of the HVAC system under (k)(6)(ii)(A) of this section, or a substantial structural part of the HVAC system, under paragraph (k)(6)(ii)(B) of this section. Accordingly, O is not required to treat the amount paid to replace the three roof-mounted heating and cooling units as a restoration of the building under paragraph (k)(1)(iv) of this section.

Example 19. Replacement of major component or substantial structural part; fire protection system P owns a building that it uses to operate its business. P pays an amount to replace the sprinkler system in the building with a new sprinkler system. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The fire protection and alarm system, including the sprinkler system, is a building system under paragraph (e)(2)(ii)(B)(*6*) of this section. As the component that provides the fire suppression mechanism in the system, the sprinkler system performs a discrete and critical function in the operation of the fire protection and alarm system and is therefore a major component of the system under paragraph (k)(6)(ii)(A) of this section. Because the sprinkler system comprises a major component of a building system, P must treat the amount paid to replace the sprinkler system as restoration to the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 20. Replacement of major component or substantial structural part; electrical system Q owns a building that it uses to operate its business. Q pays an amount to replace the wiring throughout the building with new wiring that meets building code requirements. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(*3*) of this section. As the component that distributes the electricity throughout the system, the wiring performs a discrete and critical function in the operation of the electrical system under paragraph (k)(6)(ii)(A) of this section. The wiring also comprises a large portion of the physical structure of the electrical system under paragraph (k)(6)(ii)(B) of this section. Because the wiring comprises a major component and a substantial structural part of a building system, Q must treat the amount paid to replace the wiring as a restoration to the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 21. Not a replacement of major component or substantial structural part; electrical system R owns a building that it uses to operate its business. R pays an amount to replace 30 percent of the wiring throughout the building with new wiring that meets building code requirements. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The electrical system, including the wiring, is a building system under paragraph (e)(2)(ii)(B)(*3*) of this section. All the wiring in the building comprises a major component because it performs a discrete and critical function in the operation of the electrical system. However, the portion of the wiring that was replaced is not a significant portion of the wiring major component under paragraph (k)(6)(ii)(A) of this section, nor does it comprise a substantial structural part of the electrical system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of 30 percent of the wiring is not the replacement of a major component or substantial structural part of the building, and R is not required to treat the amount paid to replace 30 percent of the wiring as a restoration to the building under paragraph (k)(1)(iv) of this section.

Example 22. Replacement of major component or substantial structural part; plumbing system S owns a building in which it conducts a retail business. The retail building has three floors. The retail building has men's and women's restrooms on two of the three floors. S decides to update the restrooms by paying an amount to replace the plumbing fixtures in all of the restrooms, including all the toilets and sinks, with modern style plumbing fixtures of similar quality and function. S does not replace the pipes connecting the fixtures to the building's plumbing system. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the plumbing fixtures, is a building system under paragraph (e)(2)(ii)(B)(*2*) of this section. All the toilets together perform a discrete and critical function in the operation of the plumbing system, and all the sinks, together, also perform a discrete and critical function in the operation of the plumbing system. Therefore, under paragraph (k)(6)(ii)(A) of this section, all the toilets comprise a major component of the plumbing system, and all the sinks comprise a major component of the plumbing system. Accordingly, S must treat the amount paid to replace all of the toilets and all of the sinks as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 23. Not replacement of major component or substantial structural part; plumbing system Assume the same facts as *Example 22* except that S does not update all the bathroom fixtures. Instead, S only pays an amount to replace 8 of the total of 20 sinks located in the various restrooms. The 8 replaced sinks, by themselves, do not comprise a significant portion of a major component (the 20 sinks) of the plumbing system under paragraph (k)(6)(ii)(A) of this section nor do they comprise a large portion of the physical structure of the plumbing system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the eight sinks does not constitute the replacement of a major component or substantial structural part of the building, and S is not required to treat the amount paid to replace the eight sinks as a restoration of a building under paragraph (k)(1)(iv) of this section.

Example 24. Replacement of major component or substantial structural part; plumbing system (i) T owns and operates a hotel building. T decides that, to attract customers and to remain competitive, it needs to update the guest rooms in its facility. Accordingly, T pays amounts to replace the bathtubs, toilets, and sinks, and to repair, repaint, and retile the bathroom walls and floors, which is necessitated by the installation of the new plumbing components. The replacement bathtubs, toilets, sinks, and tile are new and in a different style, but are similar in function and quality to the replaced items. T also pays amounts to replace certain section 1245 property, such as the guest room furniture, carpeting, drapes, table lamps, and partition walls separating the bathroom area. T completes this work on two floors at a time, closing those floors and leaving the rest of the hotel open for business. In Year 1, T pays amounts to perform the updates for 4 of the 20 hotel room floors and expects to complete the renovation of the remaining rooms over the next two years.

(ii) Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The plumbing system, including the bathtubs, toilets, and sinks, is a building system under paragraph (e)(2)(ii)(B)(*2*) of this section. All the bathtubs, together, all the toilets, together, and all the sinks together in the hotel building perform discrete and critical functions in the operation of the plumbing system under paragraph (k)(6)(ii)(A) of this section and comprise a large portion of the physical structure of the plumbing system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6)(ii) of this section, these plumbing components comprise major components and substantial structural parts of the plumbing system, and T must treat the amount paid to replace these plumbing components as a restoration of, and improvement to, the building under paragraphs (k)(1)(vi) and (k)(2) of this section. In addition, under paragraph (g)(1)(i) of this section, T must treat the costs of repairing, repainting, and retiling the bathroom walls and floors as improvement costs because these costs directly benefit and are incurred by reason of the improvement to the building. Further, under paragraph (g)(3) of this section, T must treat the costs incurred in Years 1, 2, and 3 for the bathroom remodeling as improvement costs, even though they are incurred over a period of several taxable years, because they are related amounts paid to improve the building unit of property. Accordingly, under paragraph (d)(2) of this section, T must treat all the amounts it incurs to update its hotel restrooms as an improvement to the hotel building and capitalize these amounts. In addition, under §1.263(a)–2 of the regulations, T must capitalize the amounts paid to acquire and install each section 1245 property.

Example 25. Not replacement of major component or substantial structural part; windows U owns a large office building that it uses to provide office space for employees that manage U's operations. The building has 300 exterior windows that represent 25 percent of the total surface area of the building. In Year 1, U pays an amount to replace 100 of the exterior windows that had become damaged. At the time of these replacements, U has no plans to replace any other windows in the near future. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The exterior windows are part of the building structure as defined under paragraph (e)(2)(ii)(A) of this section. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. However, the 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section or a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows does not constitute the replacement of a major component or substantial structural part of the building, and U is not required to treat the amount paid to replace the 100 windows as restoration of the building under paragraph (k)(1)(iv) of this section.

Example 26. Replacement of major component; windows Assume the same facts as *Example 25*, except that that U replaces 200 of the 300 windows on the building. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. The 200 windows comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 200 windows comprise the replacement of a major component of the building structure. Accordingly, U must treat the amount paid to replace the 200 windows as a restoration of the building under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 27. Replacement of substantial structural part; windows Assume the same facts as *Example 25*, except that the building is a modern design and the 300 windows represent 90 percent of the total surface area of the building. U replaces 100 of the 300 windows on the building. The 300 exterior windows perform a discrete and critical function in the operation of the building structure and are, therefore, a major component of the building structure under paragraph (k)(6)(i)(A) of this section. The 100 windows do not comprise a significant portion of this major component of the building structure under paragraph (k)(6)(ii)(A) of this section, however, they do comprise a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the 100 windows comprise the replacement of a substantial structural part of the building structure. Accordingly, U must treat the amount paid to replace the 100 windows as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section.

Example 28. Not replacement of major component or substantial structural part; floors V owns and operates a hotel building. V decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises less than 10 percent of the square footage of the entire hotel building. V pays an amount to replace the wood flooring in the lobby with new wood flooring of a similar quality. V did not replace any other flooring in the building. Assume that the wood flooring constitutes section 1250 property. Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The wood flooring is part of the building structure under paragraph (e)(2)(ii)(A) of this section. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. However, the lobby floors are not a significant portion of a major component (that is, all the floors) under paragraph (k)(6)(ii)(A) of this section, nor do the lobby floors comprise a substantial structural part of the building structure under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement of the lobby floors is not the replacement of a major component or substantial structural part of the building unit of property, and V is not required to treat the amount paid for the replacement of the lobby floors as a restoration to the building under paragraph (k)(1)(iv) of this section.

Example 29. Replacement of major component or substantial structural part; floors Assume the same facts as *Example 28*, except that V decides to refresh the appearance of all the public areas of the hotel building by replacing all the floors in the public areas. To that end, V pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, the ballrooms, and other public rooms throughout the hotel interiors. The public areas comprise approximately 40 percent of the square footage of the entire hotel building. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. The floors in all the public areas of the hotel comprise a significant portion of a major component (that is, all the building floors) of the building structure. Therefore, under paragraph (k)(6)(ii)(A) of this section, the replacement of all the public area floors constitutes the replacement of a major component of the building structure. Accordingly, V must treat the amount paid to replace the public area floors as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amounts as an improvement to the building under paragraph (d)(2) of this section.

Example 30. Replacement with no disposition (i) X owns an office building with four elevators serving all floors in the building. X replaces one of the elevators. The elevator is a structural component of the office building. X chooses to apply §1.168(i)–8 to taxable years beginning on or after January 1, 2012, and before the applicability date of the final regulations. In accordance with §1.168(i)–8(c)(4)(ii)(A), the office building (including its structural components) is the asset for tax disposition purposes. X also does not make the partial disposition election provided under §1.168(i)–8(d)(2) for the elevator. Thus, the retirement of the replaced elevator is not a disposition under section 168, and no loss is taken into account for purposes of paragraph (k)(1)(i) of this section.

(ii) Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The elevator system, including all four elevators, is a building system under paragraph (e)(2)(ii)(B)(*5*) of this section. The replacement elevator does not perform a discrete and critical function in the operation of elevator system under paragraph (k)(6)(ii)(A) of this section nor does it comprise a large portion of the physical structure of the elevator system under paragraph (k)(6)(ii)(B) of this section. Therefore, under paragraph (k)(6) of this section, the replacement elevator does not constitute the replacement of a major component or substantial structural part of the elevator system. Accordingly, X is not required to treat the amount paid to replace the elevator as a restoration to the building under either paragraph (k)(1)(i) or paragraph (k)(1)(vi) of this section.

Example 31. Replacement with disposition The facts are the same as in *Example 30*, except X makes the partial disposition election provided under paragraph §1.168(i)–8(d)(2) for the elevator. Although the office building (including its structural components) is the asset for disposition purposes, the result of X making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement (taking into account the applicable convention), and X recognizes a loss upon this retirement. Accordingly, X must treat the amount paid to replace the elevator as a restoration of the building under paragraphs (k)(1)(i) and (k)(2) of this section and must capitalize the amount paid as an improvement to the building under paragraph (d)(2) of this section. In addition, the replacement elevator is treated as a separate asset for tax disposition purposes pursuant to §1.168(i)–8(c)(4)(ii)(D), and for depreciation purposes pursuant to section 168(i)(6).

(l) *Capitalization of amounts to adapt property to a new or different use*—(1) *In general.* A taxpayer must capitalize as an improvement an amount paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer.

(2) *Application of adaption rule to buildings.* In the case of a building, an amount is paid to improve a building if it is paid to adapt to a new or different use a property specified under paragraph (e)(2)(ii) (building), paragraph (e)(2)(iii)(B) (condominium), paragraph (e)(2)(iv)(B) (cooperative), or paragraph (e)(2)(v)(B) (leased building or leased portion of building) of this section. For example, an amount is paid to improve a building if it is paid to adapt the building structure or any one of its buildings systems to a new or different use.

(3) *Examples.* The following examples illustrate the application of this paragraph (l) only and do not address whether capitalization is required under another provision of this section or under another provision of the Code (for example, section 263A). Unless otherwise stated, assume that the taxpayer has not properly deducted a loss for any unit of property, asset, or component of a unit of property that is removed and replaced.

Example 1. New or different use; change in building use A is a manufacturer and owns a manufacturing building that it has used for manufacturing since Year 1, when A placed it in service. In Year 30, A pays an amount to convert its manufacturing building into a showroom for its business. To convert the facility, A removes and replaces various structural components to provide a better layout for the showroom and its offices. A also repaints the building interiors as part of the conversion. When building materials are removed and replaced, A uses comparable and commercially available replacement materials. Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve A's manufacturing building if the amount adapts the building structure or any designated building system to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert the manufacturing building into a showroom adapts the building structure to a new or different use because the conversion to a showroom is not consistent with A's ordinary use of the building structure at the time it was placed in service. Therefore, A must capitalize the amount paid to convert the building into a showroom as an improvement to the building under paragraphs (d)(3) and (l) of this section.

Example 2. Not a new or different use; leased building B owns and leases out space in a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy by leasing two adjoining retail spaces. To facilitate the new lease, B pays an amount to remove the walls between the three retail spaces. Assume that the walls between spaces are part of the building and its structural components. Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve B's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt B's building structure to a new or different use because the combination of retail spaces is consistent with B's intended, ordinary use of the building structure. Therefore, the amount paid by B to remove the walls does not improve the building under paragraph (l) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

Example 3. Not a new or different use; preparing building for sale C owns a building consisting of twenty retail spaces. C decides to sell the building. In anticipation of selling the building, C pays an amount to repaint the interior walls and to refinish the hardwood floors. Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve C's building to a new or different use if it adapts the building structure or any of the building systems to a new or different use. Preparing the building for sale does not constitute a new or different use for the building structure under paragraph (l)(1) of this section. Therefore, the amount paid by C to prepare the building structure for sale does not improve the building under paragraph (l) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

Example 4. New or different use; land D owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of D's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. D discontinues manufacturing operations at the site and decides to develop the property for residential housing. In anticipation of building residential property, D pays an amount to remediate the contamination caused by D's manufacturing process. In addition, D pays an amount to regrade the land so that it can be used for residential purposes. Amounts that D pays to clean up wastes do not adapt the land to a new or different use, regardless of the extent to which the land was cleaned, because this cleanup merely returns the land to the condition it was in before the land was contaminated in

D's operations. Therefore, D is not required to capitalize the amount paid for the cleanup under paragraph (l)(1) of this section. However, the amount paid to regrade the land so that it can be used for residential purposes adapts the land to a new or different use that is inconsistent with D's intended ordinary use of the property at the time it was placed in service. Accordingly, the amounts paid to regrade the land must be capitalized as improvements to the land under paragraphs (d)(3) and (l) of this section.

Example 5. New or different use; part of building (i) E owns a building in which it operates a retail drug store. The store consists of a pharmacy for filling medication prescriptions and various departments where customers can purchase food, toiletries, home goods, school supplies, cards, over-the-counter medications, and other similar items. E decides to create a walk-in medical clinic where nurse practitioners and physicians' assistants diagnose, treat, and write prescriptions for common illnesses and injuries, administer common vaccinations, conduct physicals and wellness screenings, and provide routine lab tests and services for common chronic conditions. To create the clinic, E pays amounts to reconfigure the pharmacy building. E incurs costs to build new walls creating an examination room, lab room, reception area, and waiting area. E installs additional plumbing, electrical wiring, and outlets to support the lab. E also acquires section 1245 property, such as computers, furniture, and equipment necessary for the new clinic. E treats the amounts paid for those units of property as costs of acquiring new units of property under §1.263(a)–2.

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve E's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert part of the retail drug store building structure into a medical clinic adapts the building structure to a new and different use, because the use of the building structure to provide clinical medical services is not consistent with E's intended ordinary use of the building structure at the time it was placed in service. Similarly, the amounts paid to add to the plumbing system and the electrical systems to support the new medical services is not consistent with E's intended ordinary use of these systems when the systems were placed in service. Therefore, E must treat the amount paid for the conversion of the building structure, plumbing system, and electrical system as an improvement to the building and capitalize the amount under paragraphs (d)(3) and (l) of this section.

Example 6. Not a new or different use; part of building (i) F owns a building in which it operates a grocery store. The grocery store includes various departments for fresh produce, frozen foods, fresh meats, dairy products, toiletries, and over-the-counter medicines. The grocery store also includes separate counters for deli meats, prepared foods, and baked goods, often made to order. To better accommodate its customers' shopping needs, F decides to add a sushi bar where customers can order freshly prepared sushi from the counter for take-home or to eat at the counter. To create the sushi bar, F pays amounts to add a sushi counter and chairs, add additional wiring and outlets to support the counter, and install additional pipes and a sink, to provide for the safe handling of the food. F also pays amounts to replace flooring and wall coverings in the sushi bar area with decorative coverings to reflect more appropriate décor. Assume the sushi counter and chairs are section 1245 property, and F treats the amounts paid for those units of property as costs of acquiring new units of property under §1.263(a)–2.

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve F's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert a part of F's retail grocery into a sushi bar area does not adapt F's building structure, plumbing system, or electrical system to a new or different use, because the sale of sushi is consistent with F's intended, ordinary use of the building structure and these systems in its grocery sales business, which includes selling food to its customers at various specialized counters. Accordingly, the amount paid by F to replace the wall and floor finishes, add wiring, and add plumbing to create the sushi bar space does not improve the building unit of property under paragraph (l) of this section and is not required to be capitalized under paragraph (d)(3) of this section.

Example 7. Not a new or different use; part of building (i) G owns a hospital with various departments dedicated to the provision of clinical medical care. To better accommodate its patients' needs, G decides to modify the emergency room space to provide both emergency care and outpatient surgery. To modify the space, G pays amounts to move interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls. To complete the outpatient surgery center, G also pays amounts to install miscellaneous medical equipment necessary for the provision of surgical services. Assume the medical equipment is section 1245 property, and G treats the amounts paid for those units of property as costs of acquiring new units of property under §1.263(a)–2.

(ii) Under paragraphs (l)(2) and (e)(2)(ii) of this section, an amount is paid to improve G's building if it adapts the building structure or any of the building systems to a new or different use. Under paragraph (l)(1) of this section, the amount paid to convert part of G's emergency room into an outpatient surgery center does not adapt G's building structure or electrical system to a new or different use, because the provision of outpatient surgery is consistent with G's intended, ordinary use of the building structure and these systems in its clinical medical care business. Accordingly, the amounts paid by G to relocate interior walls, add additional wiring and outlets, replace floor tiles and doors, and repaint the walls to create outpatient surgery space do not improve the building under paragraph (l) of this section and are not required to be capitalized under paragraph (d)(3) of this section.

(m) *Optional regulatory accounting method*—(1) *In general.* This paragraph (m) provides an optional simplified method (the regulatory accounting method) for regulated taxpayers to determine whether amounts paid to repair, maintain, or improve tangible property are to be treated as deductible expenses or capital expenditures. A taxpayer that uses the regulatory accounting method described in paragraph (m)(3) of this section must use that method for property subject to regulatory accounting instead of determining whether amounts paid to repair, maintain, or improve property are capital expenditures or deductible expenses under the general principles of sections 162(a), 212, and 263(a). Thus, the capitalization rules in paragraph (d) (and the routine maintenance safe harbor described in paragraph (i)) of this section do not apply to amounts paid to repair, maintain, or improve property subject to regulatory accounting by taxpayers that use the regulatory accounting method under this paragraph (m).

(2) *Eligibility for regulatory accounting method.* A taxpayer that is engaged in a trade or business in a regulated industry is a regulated taxpayer and may use the regulatory accounting method under this paragraph (m). For purposes of this paragraph (m), a taxpayer is in a regulated industry only if the taxpayer is subject to the regulatory accounting rules of the Federal Energy Regulatory Commission (FERC), the Federal Communications Commission (FCC), or the Surface Transportation Board (STB).

(3) *Description of regulatory accounting method.* Under the regulatory accounting method, a taxpayer must follow the method of accounting for regulatory accounting purposes that it is required to follow for FERC, FCC, or STB (whichever is applicable) in determining whether an amount paid repairs, maintains, or improves property under this section. Therefore, a taxpayer must capitalize for Federal income tax purposes an amount paid that is capitalized as an improvement for regulatory accounting purposes. A taxpayer may not capitalize for Federal income tax purposes under this section an amount paid that is not capitalized as an improvement for regulatory accounting purposes. A taxpayer that uses the regulatory accounting method must use that method for all of its tangible property that is subject to regulatory accounting rules. The method does not apply to tangible property that is not subject to regulatory accounting rules. The method also does not apply to property for the taxable years in which the taxpayer elected to apply the repair allowance under §1.167(a)–11(d)(2). The regulatory accounting method is a method of accounting under section 446(a).

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

Example 1. Taxpayer subject to regulatory accounting rules of FERC W is an electric utility company that operates a power plant that generates electricity and that owns and operates network assets to transmit and distribute the electricity to its customers. W is subject to the regulatory accounting rules of FERC, and W uses the regulatory accounting method under paragraph (m) of this section. W does not capitalize on its books and records for regulatory accounting purposes the cost of repairs and maintenance performed on its turbines or its network assets. Under the regulatory accounting method, W may not capitalize for Federal income tax purposes amounts paid for repairs performed on its turbines or its network assets.

Example 2. Taxpayer not subject to regulatory accounting rules of FERC X is an electric utility company that operates a power plant to generate electricity. X previously was subject to the regulatory accounting rules of FERC, but currently X is not required to use FERC's regulatory accounting rules. X cannot use the regulatory accounting method provided in this paragraph (m).

Example 3. Taxpayer subject to regulatory accounting rules of FCC Y is a telecommunications company that is subject to the regulatory accounting rules of the FCC. Y uses the regulatory accounting method under this paragraph (m). Y's assets include a telephone central office switching center, which contains numerous switches and various switching equipment. Y capitalizes on its books and records for regulatory accounting purposes the cost of replacing each switch. Under the regulatory accounting method, Y is required to capitalize for Federal income tax purposes amounts paid to replace each switch.

Example 4. Taxpayer subject to regulatory accounting rules of STB Z is a Class I railroad that is subject to the regulatory accounting rules of the STB. Z uses the regulatory accounting method under this paragraph (m). Z capitalizes on its books and records for regulatory accounting purposes the cost of locomotive rebuilds. Under the regulatory accounting method, Z is required to capitalize for Federal income tax purposes amounts paid to rebuild its locomotives.

(n) *Election to capitalize repair and maintenance costs*—(1) *In general.* A taxpayer may elect to treat amounts paid during the taxable year for repair and maintenance (as defined under §1.162–4) to tangible property as amounts paid to improve that property under this section and as an asset subject to the allowance for depreciation if the taxpayer incurs these amounts in carrying on the taxpayer's trade or business and if the taxpayer treats these amounts as capital expenditures on its books and records regularly used in computing income (''books and records''). A taxpayer that elects to apply this paragraph (n) in a taxable year must apply this paragraph to all amounts paid for repair and maintenance to tangible property that it treats as capital expenditures on its books and records in that taxable year. Any amounts for which this election is made shall not be treated as amounts paid for repair or maintenance under §1.162–4.

(2) *Time and manner of election.* A taxpayer makes this election under this paragraph (n) by attaching a statement to the taxpayer's timely filed original Federal tax return (including extensions) for the taxable year in which the taxpayer pays amounts described under paragraph (n)(1) of this paragraph. Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. The statement must be titled ''Section 1.263(a)–3(n) Election'' and include the taxpayer's name, address, taxpayer identification number, and a statement that the taxpayer is making the election to capitalize repair and maintenance costs under §1.263(a)–3(n). In the case of a consolidated group filing a consolidated income tax return, the election is made for each member of the consolidated group by the common parent, and the statement must also include the names and taxpayer identification numbers of each member for which the election is made. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership and not by the shareholders or partners. A taxpayer making this election for a taxable year must treat any amounts paid for repairs and maintenance during the taxable year that are capitalized on the taxpayer's books and records as improvements to tangible property. The taxpayer must begin to depreciate the cost of such improvements amounts when they are placed in service by the taxpayer under the applicable provisions of the Code and regulations. An election may not be made through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make a late election, by filing an amended Federal tax return. The time and manner of electing to capitalize repair and maintenance costs under this paragraph (n) may be modified through guidance of general applicability (see §§601.601(d)(2) and 601.602 of this chapter).

(3) *Exception.* This paragraph (n) does not apply to amounts paid for repairs or maintenance of rotable or temporary spare parts to which the taxpayer applies the optional method of accounting for rotable and temporary spare parts under §1.162–3(e).

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

Example 1. Election to capitalize routine maintenance on non-rotable part (i) Q is a towboat operator that owns a fleet of towboats that it uses in its trade or business. Each towboat is equipped with two diesel-powered engines. Assume that each towboat, including its engines, is the unit of property and that a towboat has a class life of 18 years. Assume the towboat engines are not rotable spare parts under §1.162–3(c)(2). In Year 1, Q acquired a new towboat, including its two engines, and placed the towboat into service. In Year 4, Q pays amounts to perform scheduled maintenance on both engines in the towboat. Assume that none of the exceptions set out in paragraph (i)(3) of this section apply to the scheduled maintenance costs and that the scheduled maintenance on Q's towboat is within the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section. Accordingly, the amounts paid for the scheduled maintenance to its towboat engines in Year 4 are deemed not to improve the towboat and are not required to be capitalized under paragraph (d) of this section.

(ii) On its books and records, Q treats amounts paid for scheduled maintenance on its towboat engines as capital expenditures. For administrative convenience, Q decides to account for these costs in the same way for Federal income tax purposes. Under paragraph (n) of this section, in Year 4, Q may elect to capitalize the amounts paid for the scheduled maintenance on its towboat engines. If Q elects to capitalize such amounts, Q must capitalize all amounts paid for repair and maintenance to tangible property that Q treats as capital expenditures on its books and records in Year 4.

Example 2. No election to capitalize routine maintenance Assume the same facts as *Example 1*, except in Year 8, Q pays amounts to perform scheduled maintenance for a second time on the towboat engines. On its books and records, Q treats the amounts paid for this scheduled maintenance as capital expenditures. However, in Year 8, Q decides not to make the election to capitalize the amounts paid for scheduled maintenance under paragraph (n) of this section. Because Q does not make the election under paragraph (n) for Year 8, Q may apply the routine maintenance safe harbor under paragraph (i)(1)(ii) of this section to the amounts paid in Year 8, and not treat these amounts as capital expenditures. Because the election is made for each taxable year, there is no effect on the scheduled maintenance costs capitalized by Q on its Federal tax return for Year 4.

Example 3. Election to capitalize replacement of building component (i) R owns an office building that it uses to provide services to customers. The building contains a HVAC system that incorporates ten roof-mounted units that provide heating and air conditioning for different parts of the building. In Year 1, R pays an amount to replace 2 of the 10 units to address climate control problems in various offices throughout the office building. Assume that the replacement of the two units does not constitute an improvement to the HVAC system, and, accordingly, to the building unit of property under paragraph (d) of this section, and that R may deduct these amounts as repairs and maintenance under §1.162–4.

(ii) On its books and records, R treats amounts paid for the two HVAC components as capital expenditures. R determines that it would prefer to account for these amounts in the same way for Federal income tax purposes. Under this paragraph (n), in Year 1, R may elect to capitalize the amounts paid for the new HVAC components. If R elects to capitalize such amounts, R must capitalize all amounts paid for repair and maintenance to tangible property that R treats as capital expenditures on its books and records in Year 1.

(o) *Treatment of capital expenditures.* Amounts required to be capitalized under this section are capital expenditures and must be taken into account through a charge to capital account or basis, or in the case of property that is inventory in the hands of a taxpayer, through inclusion in inventory costs.

(p) *Recovery of capitalized amounts.* Amounts that are capitalized under this section are recovered through depreciation, cost of goods sold, or by an adjustment to basis at the time the property is placed in service, sold, used, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Code and regulation provisions relating to the use, sale, or disposition of property.

(q) *Accounting method changes.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(r) *Effective/applicability date*—(1) *In general.* Except for paragraphs (h), (m), and (n) of this section, this section applies to taxable years beginning on or after January 1, 2014. Paragraphs (h), (m), and (n) of this section apply to amounts paid in taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (r)(2) and (r)(3) of this section, §1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general.* Except for paragraphs (h), (m), and (n) of this section, a taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraphs (h), (m), and (n) of this section to amounts paid in taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for certain elections on 2012 or 2013 returns.* If under paragraph (r)(2)(i) of this section, a taxpayer chooses to make the election to apply the safe harbor for small taxpayers under paragraph (h) of this section or the election to capitalize repair and maintenance costs under paragraph (n) of this section for amounts paid in its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (h)(6) or paragraph (n)(2) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (h)(6) or paragraph (n)(2) of this section for the applicable taxable year by filing an amended Federal tax return (including the required statements) for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply §1.263(a)–3T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57718, Sept. 19, 2013, as amended by T.D. 9636, 79 FR 42191, July 21, 2014; T.D. 9689, 79 FR 48684, Aug. 18, 2014]

§ 1.263(a)–4 Amounts paid to acquire or create intangibles.

(a) *Overview.* This section provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. Except to the extent provided in paragraph (d)(8) of this section, the rules provided by this section do not apply to amounts paid to acquire or create tangible assets. Paragraph (b) of this section provides a general principle of capitalization. Paragraphs (c) and (d) of this section identify intangibles for which capitalization is specifically required under the general principle. Paragraph (e) of this section provides rules for determining the extent to which taxpayers must capitalize transaction costs. Paragraph (f) of this section provides a 12-month rule intended to simplify the application of the general principle to certain payments that create benefits of a brief duration. Additional rules and examples relating to these provisions are provided in paragraphs (g) through (n) of this section. The applicability date of the rules in this section is provided in paragraph (o) of this section. Paragraph (p) of this section provides rules applicable to changes in methods of accounting made to comply with this section.

(b) *Capitalization with respect to intangibles*—(1) *In general.* Except as otherwise provided in this section, a taxpayer must capitalize—

(i) An amount paid to acquire an intangible (see paragraph (c) of this section);

(ii) An amount paid to create an intangible described in paragraph (d) of this section;

(iii) An amount paid to create or enhance a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section;

(iv) An amount paid to create or enhance a future benefit identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii) of this chapter) as an intangible for which capitalization is required under this section; and

(v) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) an acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii) or (iv) of this section.

(2) *Published guidance.* Any published guidance identifying a future benefit as an intangible for which capitalization is required under paragraph (b)(1)(iv) of this section applies only to amounts paid on or after the date of publication of the guidance.

(3) *Separate and distinct intangible asset*—(i) *Definition.* The term *separate and distinct intangible asset* means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

(ii) *Creation or termination of contract rights.* Amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination, enhancement, renewal or renegotiation of such an agreement) are treated as amounts that do not create (or facilitate the creation of) a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). *See* paragraphs (d)(2), (d)(6), and (d)(7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements.

(iii) *Amounts paid in performing services.* Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3), regardless of whether the amounts result in the creation of an income stream under the agreement.

(iv) *Creation of computer software.* Except as otherwise provided in the Internal Revenue Code, the regulations thereunder, or other published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii) of this chapter), amounts paid to develop computer software are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3).

(v) *Creation of package design.* Amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). For purposes of this section, the term *package design* means the specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and other elements on a given product package, or the design of a container with respect to its shape or function.

(4) *Coordination with other provisions of the Internal Revenue Code*—(i) *In general.* Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or the regulations thereunder.

(ii) *Example.* The following example illustrates the rule of this paragraph (b)(4):

Example. On January 1, 2004, G enters into an interest rate swap agreement with unrelated counterparty H under which, for a term of five years, G is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time G and H enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 2004, H pays G a yield adjustment fee of $3,790,786. This yield adjustment fee constitutes an amount paid to create an intangible and would be capitalized under paragraph (d)(2) of this section. However, because the yield adjustment fee is a nonperiodic payment on a notional principal contract as defined in §1.446–3(c), the treatment of this fee is governed by §1.446–3 and not this section.

(c) *Acquired intangibles*—(1) *In general.* A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Examples of intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

(i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.

(iii) A financial instrument, such as—

(A) A notional principal contract;

(B) A foreign currency contract;

(C) A futures contract;

(D) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));

(E) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(F) Any other financial derivative.

(iv) An endowment contract, annuity contract, or insurance contract.

(v) Non-functional currency.

(vi) A lease.

(vii) A patent or copyright.

(viii) A franchise, trademark or tradename (as defined in §1.197–2(b)(10)).

(ix) An assembled workforce (as defined in §1.197–2(b)(3)).

(x) Goodwill (as defined in §1.197–2(b)(1)) or going concern value (as defined in §1.197–2(b)(2)).

(xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right that is not treated for Federal income tax purposes as a stripped coupon).

(xiii) A customer-based intangible (as defined in §1.197–2(b)(6)) or supplier-based intangible (as defined in §1.197–2(b)(7)).

(xiv) Computer software.

(xv) An agreement providing either party the right to use, possess or sell an intangible described in paragraphs (c)(1)(i) through (v) of this section.

(2) *Readily available software.* An amount paid to obtain a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of §1.197–2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) *Intangibles acquired from an employee.* Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are includible in the employee's income in connection with the performance of services under section 61 or 83. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Debt instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y $2,000,000 in exchange for the portfolio. The $2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for $5,000,000. The $5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

Example 3. Ownership interest in a corporation. Same as *Example 2*, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for $100,000,000. The $100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

Example 4. Customer list. N corporation, a retailer, sells its products through its catalog and mail order system. N purchases a customer list from R corporation. N pays R $100,000 in exchange for the customer list. The $100,000 paid to R constitutes an amount paid to acquire an intangible from R and must be capitalized.

Example 5. Goodwill. Z corporation pays W corporation $10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the $10,000,000 consideration paid in the transaction, $9,000,000 is allocable to tangible assets purchased from W and $1,000,000 is allocable to goodwill. The $1,000,000 allocable to goodwill constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

(d) *Created intangibles—(1) In general.* Except as provided in paragraph (f) of this section (relating to the 12-month rule), a taxpayer must capitalize amounts paid to create an intangible described in this paragraph (d). The determination of whether an amount is paid to create an intangible described in this paragraph (d) is to be made based on all of the facts and circumstances, disregarding distinctions between the labels used in this paragraph (d) to describe the intangible and the labels used by the taxpayer and other parties to the transaction.

(2) *Financial interests*—(i) In general. A taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party any of the following financial interests, whether or not the interest is regularly traded on an established market:

(A) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.

(B) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for Federal income tax purposes.

(C) A financial instrument, such as—

(*1*) A letter of credit;

(*2*) A credit card agreement;

(*3*) A notional principal contract;

(*4*) A foreign currency contract;

(*5*) A futures contract;

(*6*) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));

(*7*) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and

(*8*) Any other financial derivative.

(D) An endowment contract, annuity contract, or insurance contract that has or may have cash value.

(E) Non-functional currency.

(F) An agreement providing either party the right to use, possess or sell a financial interest described in this paragraph (d)(2).

(ii) *Amounts paid to create, originate, enter into, renew or renegotiate.* An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of a financial interest with that party.

(iii) *Renegotiate.* A taxpayer is treated as renegotiating a financial interest if the terms of the financial interest are modified. A taxpayer also is treated as renegotiating a financial interest if the taxpayer enters into a new financial interest with the same party (or substantially the same parties) to a terminated financial interest, the taxpayer could not cancel the terminated financial interest without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new financial interest. A taxpayer is treated as unable to cancel a financial interest without the consent of the other party (or parties) if, under the terms of the financial interest, the taxpayer is subject to a termination penalty and the other party (or parties) to the financial interest modifies the terms of the penalty.

(iv) *Coordination with other provisions of this paragraph (d).* An amount described in this paragraph (d)(2) that is also described elsewhere in paragraph (d) of this section is treated as described only in this paragraph (d)(2).

(v) *Coordination with §1.263(a)–5. See* §1.263(a)–5 for the treatment of borrowing costs and the treatment of amounts paid by an option writer.

(vi) *Examples.* The following examples illustrate the rules of this paragraph (d)(2):

Example 1. Loan. X corporation, a commercial bank, makes a loan to A in the principal amount of $250,000. The $250,000 principal amount of the loan paid to A constitutes an amount paid to another party to create a debt instrument with that party under paragraph (d)(2)(i)(B) of this section and must be capitalized.

Example 2. Option. W corporation owns all of the outstanding stock of X corporation. Y corporation pays W $1,000,000 in exchange for W's grant of a 3-year call option to Y permitting Y to purchase all of the outstanding stock of X at a certain price per share. Y's payment of $1,000,000 to W constitutes an amount paid to another party to create an option with that party under paragraph (d)(2)(i)(C)(*7*) of this section and must be capitalized.

Example 3. Partnership interest. Z corporation pays $10,000 to P, a partnership, in exchange for an ownership interest in P. Z's payment of $10,000 to P constitutes an amount paid to another party to create an ownership interest in a partnership with that party under paragraph (d)(2)(i)(A) of this section and must be capitalized.

Example 4. Take or pay contract. Q corporation, a producer of natural gas, pays $1,000,000 to R during 2005 to induce R corporation to enter into a 5-year ''take or pay'' gas purchase contract. Under the contract, R is liable to pay for a specified minimum amount of gas, whether or not R takes such gas. Q's payment of $1,000,000 is an amount paid to another party to induce that party to enter into an agreement providing Q the right and obligation to provide property or be compensated for such property (regardless of whether the property is provided) under paragraph (d)(2)(i)(C)(*6*) of this section and must be capitalized.

Example 5. Agreement to provide property. P corporation pays R corporation $1,000,000 in exchange for R's agreement to purchase 1,000 units of P's product at any time within the three succeeding calendar years. The agreement describes P's $1,000,000 as a sales discount. P's $1,000,000 payment is an amount paid to induce R to enter into an agreement providing P the right and obligation to provide property under paragraph (d)(2)(i)(C)(*6*) of this section and must be capitalized.

Example 6. Customer incentive payment. S corporation, a computer manufacturer, seeks to develop a business relationship with V corporation, a computer retailer. As an incentive to encourage V to purchase computers from S, S enters into an agreement with V under which S agrees that, if V purchases $20,000,000 of computers from S within 3 years from the date of the agreement, S will pay V $2,000,000 on the date that V reaches the $20,000,000 threshold. V reaches the $20,000,000 threshold during the third year of the agreement, and S pays V $2,000,000. S is not required to capitalize its payment to V under this paragraph (d)(2) because the payment does not provide S the right or obligation to provide property and does not create a separate and distinct intangible asset for S within the meaning of paragraph (b)(3)(i) of this section.

(3) *Prepaid expenses*—(i) In general. A taxpayer must capitalize prepaid expenses.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(3):

Example 1. Prepaid insurance. N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The $10,000 is a prepaid expense and must be capitalized under this paragraph (d)(3). Paragraph (d)(2) of this section does not apply to the payment because the policy has no cash value.

Example 2. Prepaid rent. X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X prepays $240,000. No other amounts are due under the lease. The $240,000 is a prepaid expense and must be capitalized under this paragraph (d)(3).

(4) *Certain memberships and privileges*—(i) *In general.* A taxpayer must capitalize amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership or privilege from that organization. A taxpayer is not required to capitalize under this paragraph (d)(4) an amount paid to obtain, renew, renegotiate or upgrade certification of the taxpayer's products, services, or business processes.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(4):

Example 1. Hospital privilege. B, a physician, pays $10,000 to Y corporation to obtain lifetime staff privileges at a hospital operated by Y. B must capitalize the $10,000 payment under this paragraph (d)(4).

Example 2. Initiation fee. X corporation pays a $50,000 initiation fee to obtain membership in a trade association. X must capitalize the $50,000 payment under this paragraph (d)(4).

Example 3. Product rating. V corporation, an automobile manufacturer, pays W corporation, a national quality ratings association, $100,000 to conduct a study and provide a rating of the quality and safety of a line of V's automobiles. V's payment is an amount paid to obtain a certification of V's product and is not required to be capitalized under this paragraph (d)(4).

Example 4. Business process certification. Z corporation, a manufacturer, seeks to obtain a certification that its quality control standards meet a series of international standards known as ISO 9000. Z pays $50,000 to an independent registrar to obtain a certification from the registrar that Z's quality management system conforms to the ISO 9000 standard. Z's payment is an amount paid to obtain a certification of Z's business processes and is not required to be capitalized under this paragraph (d)(4).

(5) *Certain rights obtained from a governmental agency*—(i) *In general.* A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(5):

Example 1. Business license. X corporation pays $15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a government agency for a right granted by that agency. Accordingly, X must capitalize the $15,000 payment.

Example 2. Bar admission. A, an individual, pays $1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely, provided A adheres to the requirements governing the practice of law in state Z. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a government agency for a right granted by that agency. Accordingly, A must capitalize the $1,000 payment.

(6) *Certain contract rights*—(i) *In general.* Except as otherwise provided in this paragraph (d)(6), a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party—

(A) An agreement providing the taxpayer the right to use tangible or intangible property or the right to be compensated for the use of tangible or intangible property;

(B) An agreement providing the taxpayer the right to provide or to receive services (or the right to be compensated for services regardless of whether the taxpayer provides such services);

(C) A covenant not to compete or an agreement having substantially the same effect as a covenant not to compete (except, in the case of an agreement that requires the performance of services, to the extent that the amount represents reasonable compensation for services actually rendered);

(D) An agreement not to acquire additional ownership interests in the taxpayer; or

(E) An agreement providing the taxpayer (as the covered party) with an annuity, an endowment, or insurance coverage.

(ii) *Amounts paid to create, originate, enter into, renew or renegotiate.* An amount paid to another party is not paid to create, originate, enter into, renew or renegotiate an agreement with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of an agreement with that party.

(iii) *Renegotiate.* A taxpayer is treated as renegotiating an agreement if the terms of the agreement are modified. A taxpayer also is treated as renegotiating an agreement if the taxpayer enters into a new agreement with the same party (or substantially the same parties) to a terminated agreement, the taxpayer could not cancel the terminated agreement without the consent of the other party (or parties), and the other party (or parties) would not have consented to the cancellation unless the taxpayer entered into the new agreement. A taxpayer is treated as unable to cancel an agreement without the consent of the other party (or parties) if, under the terms of the agreement, the taxpayer is subject to a termination penalty and the other party (or parties) to the agreement modifies the terms of the penalty.

(iv) *Right.* An agreement does not provide the taxpayer a right to use property or to provide or receive services if the agreement may be terminated at will by the other party (or parties) to the agreement before the end of the period prescribed by paragraph (f)(1) of this section. An agreement is not terminable at will if the other party (or parties) to the agreement is economically compelled not to terminate the agreement until the end of the period prescribed by paragraph (f)(1) of this section. All of the facts and circumstances will be considered in determining whether the other party (or parties) to an agreement is economically compelled not to terminate the agreement. An agreement also does not provide the taxpayer the right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services.

(v) *De minimis amounts.* A taxpayer is not required to capitalize amounts paid to another party (or parties) to create, originate, enter into, renew or renegotiate with that party (or those parties) an agreement described in paragraph (d)(6)(i) of this section if the aggregate of all amounts paid to that party (or those parties) with respect to the agreement does not exceed $5,000. If the aggregate of all amounts paid to the other party (or parties) with respect to that agreement exceeds $5,000, then all amounts must be capitalized. For purposes of this paragraph (d)(6), an amount paid in the form of property is valued at its fair market value at the time of the payment. In general, a taxpayer must determine whether the rules of this paragraph (d)(6)(v) apply by accounting for the specific amounts paid with respect to each agreement. However, a taxpayer that reasonably expects to create, originate, enter into, renew or renegotiate at least 25 similar agreements during the taxable year may establish a pool of agreements for purposes of determining the amounts paid with respect to the agreements in the pool. Under this pooling method, the amount paid with respect to each agreement included in the pool is equal to the average amount paid with respect to all agreements included in the pool. A taxpayer computes the average amount paid with respect to all agreements included in the pool by dividing the sum of all amounts paid with respect to all agreements included in the pool by the number of agreements included in the pool. See paragraph (h) of this section for additional rules relating to pooling.

(vi) *Exception for lessee construction allowances.* Paragraph (d)(6)(i) of this section does not apply to amounts paid by a lessor to a lessee as a construction allowance to the extent the lessee expends the amount for the tangible property that is owned by the lessor for Federal income tax purposes (*see,* for example, section 110).

(vii) *Examples.* The following examples illustrate the rules of this paragraph (d)(6):

Example 1. New lease agreement. V seeks to lease commercial property in a prominent downtown location of city R. V pays Z, the owner of the commercial property, $50,000 in exchange for Z entering into a 10-year lease with V. V's payment is an amount paid to another party to enter into an agreement providing V the right to use tangible property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, V must capitalize the entire $50,000 payment.

Example 2. Modification of lease agreement. Partnership Y leases a piece of equipment for use in its business from Z corporation. When the lease has a remaining term of 3 years, Y requests that Z modify the existing lease by extending the remaining term by 5 years. Y pays $50,000 to Z in exchange for Z's agreement to modify the existing lease. Y's payment of $50,000 is an amount paid to another party to renegotiate an agreement providing Y the right to use property. Because the $50,000 payment exceeds $5,000, no portion of the amount paid to Z is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, Y must capitalize the entire $50,000 payment.

Example 3. Modification of lease agreement. In 2004, R enters into a 5-year, noncancelable lease of a mainframe computer for use in its business. R subsequently determines that the mainframe computer that R is leasing is no longer adequate for its needs. In 2006, R and P corporation (the lessor) agree to terminate the 2004 lease and to enter into a new 5-year lease for a different and more powerful mainframe computer. R pays P a $75,000 early termination fee. P would not have agreed to terminate the 2004 lease unless R agreed to enter into the 2006 lease. R's payment of $75,000 is an amount paid to another party to renegotiate an agreement providing R the right to use property. Because the $75,000 payment exceeds $5,000, no portion of the amount paid to P is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(A) of this section, R must capitalize the entire $75,000 payment.

Example 4. Modification of lease agreement. Same as *Example 3,* except the 2004 lease agreement allows R to terminate the lease at any time subject to a $75,000 early termination fee. Because R can terminate the lease without P's approval, R's payment of $75,000 is not an amount paid to another party to renegotiate an agreement. Accordingly, R is not required to capitalize the $75,000 payment under this paragraph (d)(6).

Example 5. Modification of lease agreement. Same as *Example 4,* except P agreed to reduce the early termination fee to $60,000. Because R did not pay an amount to renegotiate the early termination fee, R's payment of $60,000 is not an amount paid to another party to renegotiate an agreement. Accordingly, R is not required to capitalize the $60,000 payment under this paragraph (d)(6).

Example 6. Covenant not to compete. R corporation enters into an agreement with A, an individual, that prohibits A from competing with R for a period of three years. To encourage A to enter into the agreement, R agrees to pay A $100,000 upon the signing of the agreement. R's payment is an amount paid to another party to enter into a covenant not to compete. Because the $100,000 payment exceeds $5,000, no portion of the amount paid to A is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(C) of this section, R must capitalize the entire $100,000 payment.

Example 7. Standstill agreement. During 2004 through 2005, X corporation acquires a large minority interest in the stock of Z corporation. To ensure that X does not take control of Z, Z pays X $5,000,000 for a standstill agreement under which X agrees not to acquire any more stock in Z for a period of 10 years. Z's payment is an amount paid to another party to enter into an agreement not to acquire additional ownership interests in Z. Because the $5,000,000 payment exceeds $5,000, no portion of the amount paid to X is *de minimis* for purposes of paragraph (d)(6)(v) of this section. Under paragraph (d)(6)(i)(D) of this section, Z must capitalize the entire $5,000,000 payment.

Example 8. Signing bonus. Employer B pays a $25,000 signing bonus to employee C to induce C to come to work for B. C can leave B's employment at any time to work for a competitor of B and is not required to repay the $25,000 bonus to B. Because C is not economically compelled to continue his employment with B, B's payment does not provide B the right to receive services from C. Accordingly, B is not required to capitalize the $25,000 payment.

Example 9. Renewal. In 2000, M corporation and N corporation enter into a 5-year agreement that gives M the right to manage N's investment portfolio. In 2005, N has the option of renewing the agreement for another three years. During 2004, M pays $10,000 to send several employees of N to an investment seminar. M pays the $10,000 to help develop and maintain its business relationship with N with the expectation that N will renew its agreement with M in 2005. Because M's payment is not contingent on N agreeing to renew the agreement, M's payment is not an amount paid to renew an agreement under paragraph (d)(6)(ii) of this section and is not required to be capitalized.

Example 10. De minimis payments. X corporation is engaged in the business of providing wireless telecommunications services to customers. To induce customer B to enter into a 3-year non-cancelable telecommunications contract, X provides B with a free wireless telephone. The fair market value of the wireless telephone is $300 at the time it is provided to B. X's provision of a wireless telephone to B is an amount paid to B to induce B to enter into an agreement providing X the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Because the amount of the inducement is $300, the amount of the inducement is *de minimis* under paragraph (d)(6)(v) of this section. Accordingly, X is not required to capitalize the amount of the inducement provided to B.

(7) *Certain contract terminations*—(i) *In general.* A taxpayer must capitalize amounts paid to another party to terminate—

(A) A lease of real or tangible personal property between the taxpayer (as lessor) and that party (as lessee);

(B) An agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business (other than an intangible described in paragraph (c)(1)(i) through (iv) of this section or a financial interest described in paragraph (d)(2) of this section); or

(C) An agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.

(ii) *Certain break-up fees.* Paragraph (d)(7)(i) of this section does not apply to the termination of a transaction described in §1.263(a)–5(a) (relating to an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). *See* §1.263(a)–5(c)(8) for rules governing the treatment of amounts paid to terminate a transaction to which that section applies.

(iii) *Examples.* The following examples illustrate the rules of this paragraph (d)(7):

Example 1. Termination of exclusive license agreement. On July 1, 2005, N enters into a license agreement with R corporation under which N grants R the exclusive right to manufacture and distribute goods using N's design and trademarks for a period of 10 years. On June 30, 2007, N pays R $5,000,000 in exchange for R's agreement to terminate the exclusive license agreement. N's payment to terminate its license agreement with R constitutes a payment to terminate an exclusive license to use the taxpayer's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, N must capitalize its $5,000,000 payment to R.

Example 2. Termination of exclusive distribution agreement. On March 1, 2005, L, a manufacturer, enters into an agreement with M granting M the right to be the sole distributor of L's products in state X for 10 years. On July 1, 2008, L pays M $50,000 in exchange for M's agreement to terminate the distribution agreement. L's payment to terminate its agreement with M constitutes a payment to terminate an exclusive right to acquire L's property, as described in paragraph (d)(7)(i)(B) of this section. Accordingly, L must capitalize its $50,000 payment to M.

Example 3. Termination of covenant not to compete. On February 1, 2005, Y corporation enters into a covenant not to compete with Z corporation that prohibits Y from competing with Z in city V for a period of 5 years. On January 31, 2007, Y pays Z $1,000,000 in exchange for Z's agreement to terminate the covenant not to compete. Y's payment to terminate the covenant not to compete with Z constitutes a payment to terminate an agreement that prohibits Y from competing with Z, as described in paragraph (d)(7)(i)(C) of this section. Accordingly, Y must capitalize its $1,000,000 payment to Z.

Example 4. Termination of merger agreement. N corporation and U corporation enter into an agreement under which N agrees to merge into U. Subsequently, N pays U $10,000,000 to terminate the merger agreement. As provided in paragraph (d)(7)(ii) of this section, N's $10,000,000 payment to terminate the merger agreement with U is not required to be capitalized under this paragraph (d)(7). In addition, N's $10,000,000 does not create a separate and distinct intangible asset for N within the meaning of paragraph (b)(3)(i) of this section. (*See* §1.263(a)–5 for additional rules regarding termination of merger agreements).

(8) *Certain benefits arising from the provision, production, or improvement of real property*—(i) *In general.* A taxpayer must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person (except to the extent the real property is sold for fair market value) and if the real property can reasonably be expected to produce significant economic benefits to the taxpayer after the transfer. A taxpayer also must capitalize amounts paid to produce or improve real property owned by another (except to the extent the taxpayer is selling services at fair market value to produce or improve the real property) if the real property can reasonably be expected to produce significant economic benefits for the taxpayer.

(ii) *Exclusions.* A taxpayer is not required to capitalize an amount under paragraph (d)(8)(i) of this section if the taxpayer transfers real property or pays an amount to produce or improve real property owned by another in exchange for services, the purchase or use of property, or the creation of an intangible described in paragraph (d) of this section (other than in this paragraph (d)(8)). The preceding sentence does not apply to the extent the taxpayer does not receive fair market value consideration for the real property that is relinquished or for the amounts that are paid by the taxpayer to produce or improve real property owned by another.

(iii) *Real property.* For purposes of this paragraph (d)(8), real property includes property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as roads, bridges, tunnels, pavements, wharves and docks, breakwaters and sea walls, elevators, power generation and transmission facilities, and pollution control facilities.

(iv) *Impact fees and dedicated improvements.* Paragraph (d)(8)(i) of this section does not apply to amounts paid to satisfy one-time charges imposed by a State or local government against new development (or expansion of existing development) to finance specific offsite capital improvements for general public use that are necessitated by the new or expanded development. In addition, paragraph (d)(8)(i) of this section does not apply to amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a State or local government for dedication to the general public use, and are maintained by the State or local government. See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in this paragraph (d)(8)(iv).

(v) *Examples.* The following examples illustrate the rules of this paragraph (d)(8):

Example 1. Amount paid to produce real property owned by another. W corporation operates a quarry on the east side of a river in city Z and a crusher on the west side of the river. City Z's existing bridges are of insufficient capacity to be traveled by trucks in transferring stone from W's quarry to its crusher. As a result, the efficiency of W's operations is greatly reduced. W contributes $1,000,000 to city Z to defray in part the cost of constructing a publicly owned bridge capable of accommodating W's trucks. W's payment to city Z is an amount paid to produce or improve real property (within the meaning of paragraph (d)(8)(iii) of this section) that can reasonably be expected to produce significant economic benefits for W. Under paragraph (d)(8)(i) of this section, W must capitalize the $1,000,000 paid to city Z.

Example 2. Transfer of real property to another. K corporation, a shipping company, uses smaller vessels to unload its ocean-going vessels at port X. There is no natural harbor at port X, and during stormy weather the transfer of freight between K's ocean vessels and port X is extremely difficult and sometimes impossible, which can be very costly to K. Consequently, K constructs a short breakwater at a cost of $50,000. The short breakwater, however, is inadequate, so K persuades the port authority to build a larger breakwater that will allow K to unload its vessels at any time of the year and during all kinds of weather. K contributes the short breakwater and pays $200,000 to the port authority for use in building the larger breakwater. Because the transfer of the small breakwater and $200,000 is reasonably expected to produce significant economic benefits for K, K must capitalize both the adjusted basis of the small breakwater (determined at the time the small breakwater is contributed) and the $200,000 payment under this paragraph (d)(8).

Example 3. Dedicated improvements. X corporation is engaged in the development and sale of residential real estate. In connection with a residential real estate project under construction by X in city Z, X is required by city Z to construct ingress and egress roads to and from its project and immediately transfer the roads to city Z for dedication to general public use. The roads will be maintained by city Z. X pays its subcontractor $100,000 to construct the ingress and egress roads. X's payment is a dedicated improvement within the meaning of paragraph (d)(8)(iv) of this section. Accordingly, X is not required to capitalize the $100,000 payment under this paragraph (d)(8). See section 263A and the regulations thereunder for capitalization rules that apply to amounts referred to in paragraph (d)(8)(iv) of this section.

(9) *Defense or perfection of title to intangible property*—(i) *In general.* A taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property.

(ii) *Certain break-up fees.* Paragraph (d)(9)(i) of this section does not apply to the termination of a transaction described in § 1.263(a)–5(a) (relating to an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions). *See* § 1.263(a)–5 for rules governing the treatment of amounts paid to terminate a transaction to which that section applies. Paragraph (d)(9)(i) of this section also does not apply to an amount paid to another party to terminate an agreement that grants that party the right to purchase the taxpayer's intangible property.

(iii) *Example.* The following example illustrates the rules of this paragraph (d)(9):

Example. Defense of title. R corporation claims to own an exclusive patent on a particular technology. U corporation brings a lawsuit against R, claiming that U is the true owner of the patent and that R stole the technology from U. The sole issue in the suit involves the validity of R's patent. R chooses to settle the suit by paying U $100,000 in exchange for U's release of all future claim to the patent. R's payment to U is an amount paid to defend or perfect title to intangible property under paragraph (d)(9) of this section and must be capitalized.

(e) *Transaction costs*—(1) *Scope of facilitate*—(i) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

(ii) *Treatment of termination payments.* An amount paid to terminate (or acilitate the termination of) an existing agreement does not facilitate the acquisition or creation of another agreement under this section. See paragraph (d)(6)(iii) of this section for the treatment of termination fees paid to the other party (or parties) of a renegotiated agreement.

(iii) *Special rule for contracts.* An amount is treated as not paid in the process of investigating or otherwise pursuing the creation of an agreement described in paragraph (d)(2) or (d)(6) of this section if the amount relates to activities performed before the earlier of the date the taxpayer begins preparing its bid for the agreement or the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement.

(iv) *Borrowing costs.* An amount paid to facilitate a borrowing does not facilitate an acquisition or creation of an intangible described in paragraphs (b)(1)(i) through (iv) of this section. *See* §§ 1.263(a)–5 and 1.446–5 for the treatment of an amount paid to facilitate a borrowing.

(v) *Special rule for stock redemption costs of open-end regulated investment companies.* An amount paid by an open-end regulated investment company (within the meaning of section 851) to facilitate a redemption of its stock is treated as an amount that does not facilitate the acquisition of an intangible under this section.

(2) *Coordination with paragraph (d) of this section.* In the case of an amount paid to facilitate the creation of an intangible described in paragraph (d) of this section, the provisions of this paragraph (e) apply regardless of whether a payment described in paragraph (d) is made.

(3) *Transaction.* For purposes of this section, the term *transaction* means all of the factual elements comprising an acquisition or creation of an intangible and includes a series of steps carried out as part of a single plan. Thus, a transaction can involve more than one invoice and more than one intangible. For example, a purchase of intangibles under one purchase agreement constitutes a single transaction, notwithstanding the fact that the acquisition involves multiple intangibles and the amounts paid to facilitate the acquisition are capable of being allocated among the various intangibles acquired.

(4) *Simplifying conventions*—(i) *In general.* For purposes of this section, employee compensation (within the meaning of paragraph (e)(4)(ii) of this section), overhead, and *de minimis* costs (within the meaning of paragraph (e)(4)(iii) of this section) are treated as amounts that do not facilitate the acquisition or creation of an intangible.

(ii) *Employee compensation*—(A) *In general.* The term *employee compensation* means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(B) *Certain amounts treated as employee compensation.* For purposes of this section, a guaranteed payment to a partner in a partnership is treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes of this section. However, an amount paid to a director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services. In the case of an affiliated group of corporations filing a consolidated Federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are provided at a time during which both members are affiliated.

(iii) *De minimis costs*—(A) *In general.* Except as provided in paragraph (e)(4)(iii)(B) of this section, the term *de minimis costs* means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed $5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed $5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are *de minimis* costs within the meaning of this paragraph (e)(4)(iii)(A). For purposes of this paragraph (e)(4)(iii), an amount paid in the form of property is valued at its fair market value at the time of the payment. In determining the amount of transaction costs paid in the process of investigating or otherwise pursuing a transaction, a taxpayer generally must account for the specific costs paid with respect to each transaction. However, a taxpayer that reasonably expects to enter into at least 25 similar transactions during the taxable year may establish a pool of similar transactions for purposes of determining the amount of transaction costs paid in the process of investigating or otherwise pursuing the transactions in the pool. Under this pooling method, the amount of transaction costs paid in the process of investigating or otherwise pursuing each transaction included in the pool is equal to the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool. A taxpayer computes the average transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by dividing the sum of all transaction costs paid in the process of investigating or otherwise pursuing all transactions included in the pool by the number of transactions included in the pool. *See* paragraph (h) of this section for additional rules relating to pooling.

(B) *Treatment of commissions.* The term *de minimis costs* does not include commissions paid to facilitate the acquisition of an intangible described in paragraphs (c)(1)(i) through (v) of this section or to facilitate the creation, origination, entrance into, renewal or renegotiation of an intangible described in paragraph (d)(2)(i) of this section.

(iv) *Election to capitalize.* A taxpayer may elect to treat employee compensation, overhead, or *de minimis* costs paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or *de minimis* costs, or to any combination thereof. For example, a taxpayer may elect to treat overhead and *de minimis* costs, but not employee compensation, as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer's timely filed original Federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (e)(4)(iv) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(5) *Examples.* The following examples illustrate the rules of this paragraph (e):

Example 1. Costs to facilitate. In December 2005, R corporation, a calendar year taxpayer, enters into negotiations with X corporation to lease commercial property from X for a period of 25 years. R pays A, its outside legal counsel, $4,000 in December 2005 for services rendered by A during December in assisting with negotiations with X. In January 2006, R and X finalize the terms of the lease and execute the lease agreement. R pays B, another of its outside legal counsel, $2,000 in January 2006 for services rendered by B during January in drafting the lease agreement. The agreement between R and X is an agreement providing R the right to use property, as described in paragraph (d)(6)(i)(A) of this section. R's payments to its outside counsel are amounts paid to facilitate the creation of the agreement. As provided in paragraph (e)(4)(iii)(A) of this section, R must aggregate its transaction costs for purposes of determining whether the transaction costs are *de minimis.* Because R's aggregate transaction costs exceed $5,000, R's transaction costs are not *de minimis* costs within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, R must capitalize the $4,000 paid to A and the $2,000 paid to B under paragraph (b)(1)(v) of this section.

Example 2. Costs to facilitate. Partnership X leases its manufacturing equipment from Y corporation under a 10-year lease. During 2005, when the lease has a remaining term of 4 years, X enters into a written agreement with Z corporation, a competitor of Y, under which X agrees to lease its manufacturing equipment from Z, subject to the condition that X first successfully terminates its lease with Y. X pays Y $50,000 in exchange for Y's agreement to terminate the equipment lease. Under paragraph (e)(1)(ii), X's $50,000 payment does not facilitate the creation of the new lease with Z. In addition, X's $50,000 payment does not terminate an agreement described in paragraph (d)(7) of this section. Accordingly, X is not required to capitalize the $50,000 termination payment under this section.

Example 3. Costs to facilitate. W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 5 years. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. Under paragraph (e)(1)(i) of this section, W's payment to its outside counsel is an amount paid to facilitate the creation of that agreement. As provided by paragraph (e)(2) of this section, W must capitalize its $7,000 payment to outside counsel notwithstanding the fact that W made no payment described in paragraph (d)(6)(i) of this section.

Example 4. Costs to facilitate. U corporation, which owns a majority of the common stock of T corporation, votes its controlling interest in favor of a perpetual extension of T's charter. M, a minority shareholder in T, votes against the extension. Under applicable state law, U is required to purchase the stock of T held by M. When U and M are unable to agree on the value of M's shares, U brings an action in state court to appraise the value of M's stock interest. U pays attorney, accountant and appraisal fees of $25,000 for services rendered in connection with the negotiation and litigation with M. Because U's attorney, accountant and appraisal costs help establish the purchase price of M's stock, U's $25,000 payment facilitates the acquisition of stock. Accordingly, U must capitalize the $25,000 payment under paragraph (b)(1)(v) of this section.

Example 5. Costs to facilitate. For several years, H corporation has provided services to J corporation whenever requested by J. H wants to enter into a multiple-year contract with J that would give H the right to provide services to J. On June 10, 2004, H starts to prepare a bid to provide services to J and pays a consultant $15,000 to research potential competitors. On August 10, 2004, H raises the possibility of a multi-year contract with J. On October 10, 2004, H and J enter into a contract giving H the right to provide services to J for five years. During 2004, H pays $7,000 to travel to the city in which J's offices are located to continue providing services to J under their prior arrangement and pays $6,000 for travel to the city in which J's offices are located to further develop H's business relationship with J (for example, to introduce new employees, update J on current developments and take J's executives to dinner). H also pays $8,000 for travel costs to meet with J to discuss and negotiate the contract. Because the contract gives H the right to provide services to J, H must capitalize amounts paid to facilitate the creation of the contract. The $7,000 of travel expenses paid to provide services to J under their prior arrangement does not facilitate the creation of the contract and is not required to be capitalized, regardless of when the travel occurs. The $6,000 of travel expenses paid to further develop H's business relationship with J is paid in the process of pursuing the contract (and therefore must be capitalized) only to the extent the expenses relate to travel on or after June 10, 2004 (the date H begins to prepare a bid) and before October 11, 2004 (the date after H and J enter into the contract). The $8,000 of travel expenses paid to meet with J to discuss and negotiate the contract is paid in the process of pursuing the contact and must be capitalized. The $15,000 of consultant fees is paid to investigate the contract and also must be capitalized.

Example 6. Costs that do not facilitate. X corporation brings a legal action against Y corporation to recover lost profits resulting from Y's alleged infringement of X's copyright. Y does not challenge X's copyright, but argues that it did not infringe upon X's copyright. X pays its outside counsel $25,000 for legal services rendered in pursuing the suit against Y. Because X's title to its copyright is not in question, X's action against Y does not involve X's defense or perfection of title to intangible property. Thus, the amount paid to outside counsel does not facilitate the creation of an intangible described in paragraph (d)(9) of this section. Accordingly, X is not required to capitalize its $25,000 payment under this section.

Example 7. De minimis rule. W corporation, a commercial bank, acquires a portfolio containing 100 loans from Y corporation. As part of the acquisition, W pays an independent appraiser a fee of $10,000 to appraise the portfolio. The fee is an amount paid to facilitate W's acquisition of an intangible. The acquisition of the loan portfolio is a single transaction within the meaning of paragraph (e)(3) of this section. Because the amount paid to facilitate the transaction exceeds $5,000, the amount is not *de minimis* as defined in paragraph (e)(4)(iii)(A) of this section. Accordingly, W must capitalize the $10,000 fee under paragraph (b)(1)(v) of this section.

Example 8. Compensation and overhead. P corporation, a commercial bank, maintains a loan acquisition department whose sole function is to acquire loans from other financial institutions. As provided in paragraph (e)(4)(i) of this section, P is not required to capitalize any portion of the compensation paid to the employees in its loan acquisition department or any portion of its overhead allocable to the loan acquisition department.

(f) *12-month rule*—(1) *In general.* Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of—

(i) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(ii) The end of the taxable year following the taxable year in which the payment is made.

(2) *Duration of benefit for contract terminations.* For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer that lasts for the unexpired term of the agreement immediately before the date of the termination. If the terms of a contract or other agreement described in paragraph (d)(7)(i) of this section permit the taxpayer to terminate the contract or agreement after a notice period, amounts paid by the taxpayer to terminate the contract or agreement before the end of the notice period create a benefit for the taxpayer that lasts for the amount of time by which the notice period is shortened.

(3) *Inapplicability to created financial interests and self-created amortizable section 197 intangibles.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible described in paragraph (d)(2) of this section (relating to amounts paid to create financial interests) or to amounts paid to create (or facilitate the creation of) an intangible that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) *Inapplicability to rights of indefinite duration.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer's violation of the terms of the license.

(5) *Rights subject to renewal*—(i) *In general.* For purposes of paragraph (f)(1) of this section, the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal.

(ii) *Reasonable expectancy of renewal.* The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) *Renewal history.* The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) *Economics of the transaction.* The fact that renewal is necessary for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays $14,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of $1,000 per month, the fact that renewal is necessary for the taxpayer to earn back its $14,000 payment is evidence of a reasonable expectancy of renewal.

(C) *Likelihood of renewal by other party.* Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others is not evidence of a reasonable expectancy of renewal.

(D) *Terms of renewal.* The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(E) *Terminations.* The fact that similar rights are typically terminated prior to renewal is evidence of a lack of a reasonably expectancy of renewal.

(iii) *Safe harbor pooling method.* In lieu of applying the reasonable expectancy of renewal test described in paragraph (f)(5)(ii) of this section to each separate right created during a taxable year, a taxpayer that reasonably expects to enter into at least 25 similar rights during the taxable year may establish a pool of similar rights for which the initial term does not extend beyond the period prescribed in paragraph (f)(1) of this section and may elect to apply the reasonable expectancy of renewal test to that pool. *See* paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except *de minimis* costs described in paragraph (d)(6)(v) of this section) paid to create the rights included in the pool and all amounts paid to facilitate the creation of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that extends beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section and the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible. The amount determined by multiplying the aggregate amount described in paragraph (f)(5)(iii)(A) of this section by the percentage of rights in the pool that are not reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section is not required to be capitalized under this section.

(6) *Coordination with section 461.* In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See §1.461–4 for rules relating to economic performance.

(7) *Election to capitalize.* A taxpayer may elect not to apply the rule contained in paragraph (f)(1) of this section. An election made under this paragraph (f)(7) applies to all similar transactions during the taxable year to which paragraph (f)(1) of this section would apply (but for the election under this paragraph (f)(7)). For example, a taxpayer may elect under this paragraph (f)(7) to capitalize its costs of prepaying insurance contracts for 12 months, but may continue to apply the rule in paragraph (f)(1) to its costs of entering into non-renewable, 12-month service contracts. A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (f)(7) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(8) *Examples.* The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer that does not have a short taxable year in any taxable year and has not made an election under paragraph (f)(7) of this section:

Example 1. Prepaid expenses. On December 1, 2005, N corporation pays a $10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on February 1, 2006. The amount paid by N is a prepaid expense described in paragraph (d)(3) of this section and not paragraph (d)(2) of this section. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the $10,000 payment.

Example 2. Prepaid expenses. (i) Assume the same facts as in *Example 1*, except that the policy has a term beginning on December 15, 2005. The 12-month rule of this paragraph (f) applies to the $10,000 payment because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, N is not required to capitalize the $10,000 payment.

(ii) Alternatively, assume N capitalizes prepaid expenses for financial accounting and reporting purposes and elects under paragraph (f)(7) of this section not to apply the 12-month rule contained in paragraph (f)(1) of this section. N must capitalize the $10,000 payment for Federal income tax purposes.

Example 3. Financial interests. On October 1, 2005, X corporation makes a 9-month loan to B in the principal amount of $250,000. The principal amount of the loan to B constitutes an amount paid to create or originate a financial interest under paragraph (d)(2)(i)(B) of this section. The 9-month term of the loan does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, X must capitalize the $250,000 loan amount.

Example 4. Financial interests. X corporation owns all of the outstanding stock of Z corporation. On December 1, 2005, Y corporation pays X $1,000,000 in exchange for X's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(i)(C)(*7*) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must capitalize the $1,000,000 payment.

Example 5. License. (i) On July 1, 2005, R corporation pays $10,000 to state X to obtain a license to operate a business in state X for a period of 5 years. The terms of the license require R to pay state X an annual fee of $500 due on July 1, 2005, and each of the succeeding four years. R pays the $500 fee on July 1 as required by the license.

(ii) R's payment of $10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R's payment creates rights or benefits for R that extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and beyond the end of 2006 (the taxable year following the taxable year in which the payment is made), the rules of this paragraph (f) do not apply to R's payment. Accordingly, R must capitalize the $10,000 payment.

(iii) R's payment of each $500 annual fee is a prepaid expense described in paragraph (d)(3) of this section. R is not required to capitalize the $500 fee in each taxable year. The rules of this paragraph (f) apply to each such payment because each payment provides a right or benefit to R that does not extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and does not extend beyond the end of the taxable year following the taxable year in which the payment is made.

Example 6. Lease. On December 1, 2005, W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2005. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. W's $7,000 payment to its outside counsel is an amount paid to facilitate W's creation of the lease as described in paragraph (e)(1)(i) of this section. The 12-month rule of this paragraph (f) applies to the $7,000 payment because the right or benefit that the $7,000 payment facilitates the creation of neither extends more than 12 months beyond December 1, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, W is not required to capitalize its payment to its outside counsel.

Example 7. Certain contract terminations. V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V and A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A $100,000 in exchange for A's agreement to terminate the lease. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the taxable year following the taxable year in which the payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the $100,000 payment.

Example 8. Certain contract terminations. Assume the same facts as in *Example 7,* except that the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the $100,000 payment.

Example 9. Certain contract terminations. Assume the same facts as in *Example 7,* except that either party can terminate the lease upon 12 months notice. When the lease has a remaining unexpired term of 5 years, V wants to terminate the lease, however, V does not want to wait another 12 months. V pays A $50,000 for the ability to terminate the lease with one month's notice. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 11 months, the time by which the notice period is shortened. The 12-month rule of this paragraph (f) applies to V's $50,000 payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the $50,000 payment.

Example 10. Coordination with section 461. (i) U corporation leases office space from W corporation at a monthly rental rate of $2,000. On August 1, 2005, U prepays its office rent expense for the first six months of 2006 in the amount of $12,000. For purposes of this example, it is assumed that the recurring item exception provided by §1.461–5 does not apply and that the lease between W and U is not a section 467 rental agreement as defined in section 467(d).

(ii) Under §1.461–4(d)(3), U's prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U's prepayment of rent does not occur until 2006, U's prepaid rent is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to U's prepayment of its rent.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in §1.461–4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the $12,000 payment because the rights or benefits attributable to U's prepayment of its rent do not extend beyond December 31, 2006. Accordingly, U is not required to capitalize its prepaid rent.

Example 11. Coordination with section 461. N corporation pays R corporation, an advertising and marketing firm, $40,000 on August 1, 2005, for advertising and marketing services to be provided to N throughout calendar year 2006. For purposes of this example, it is assumed that the recurring item exception provided by §1.461–5 does not apply. Under §1.461–4(d)(2), N's payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N's prepaid advertising expense does not occur until 2006, N's prepaid advertising expense is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to N's payment.

(g) *Treatment of capitalized costs*—(1) *In general.* An amount required to be capitalized by this section is not currently deductible under section 162. Instead, the amount generally is added to the basis of the intangible acquired or created. See section 1012.

(2) *Financial instruments.* In the case of a financial instrument described in paragraph (c)(1)(iii) or (d)(2)(i)(C) of this section, notwithstanding paragraph (g)(1) of this section, if under other provisions of law the amount required to be capitalized is not required to be added to the basis of the intangible acquired or created, then the other provisions of law will govern the tax treatment of the amount.

(h) *Special rules applicable to pooling*—(1) *In general.* Except as otherwise provided, the rules of this paragraph (h) apply to the pooling methods described in paragraph (d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights), paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs), and paragraph (f)(5)(iii) of this section (relating to the application of the 12-month rule to renewable rights).

(2) *Method of accounting.* A pooling method authorized by this section constitutes a method of accounting for purposes of section 446. A taxpayer that adopts or changes to a pooling method authorized by this section must use the method for the year of adoption and for all subsequent taxable years during which the taxpayer qualifies to use the pooling method unless a change to another method is required by the Commissioner in order to clearly reflect income, or unless permission to change to another method is granted by the Commissioner as provided in §1.446–1(e).

(3) *Adopting or changing to a pooling method.* A taxpayer adopts (or changes to) a pooling method authorized by this section for any taxable year by establishing one or more pools for the taxable year in accordance with the rules governing the particular pooling method and the rules prescribed by this paragraph (h), and by using the pooling method to compute its taxable income for the year of adoption (or change).

(4) *Definition of pool.* A taxpayer may use any reasonable method of defining a pool of similar transactions, agreements or rights, including a method based on the type of customer or the type of product or service provided under a contract. However, a taxpayer that pools similar transactions, agreements or rights must include in the pool all similar transactions, agreements or rights created during the taxable year. For purposes of the pooling methods described in paragraph (d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs), an agreement (or a transaction) is treated as not similar to

other agreements (or transactions) included in the pool if the amount at issue with respect to that agreement (or transaction) is reasonably expected to differ significantly from the average amount at issue with respect to the other agreements (or transactions) properly included in the pool.

(5) *Consistency requirement.* A taxpayer that uses the pooling method described in paragraph (f)(5)(iii) of this section for purposes of applying the 12-month rule to a right or benefit—

(i) Must use the pooling methods described in paragraph (d)(6)(v) of this section (relating to *de minimis* rules applicable to certain contract rights) and paragraph (e)(4)(iii)(A) of this section (relating to *de minimis* rules applicable to transaction costs) for purposes of determining the amount paid to create, or facilitate the creation of, the right or benefit; and

(ii) Must use the same pool for purposes of paragraph (d)(6)(v) of this section and paragraph (e)(4)(iii)(A) of this section as is used for purposes of paragraph (f)(5)(iii) of this section.

(6) *Additional guidance pertaining to pooling.* The Internal Revenue Service may publish guidance in the Internal Revenue Bulletin (*see* §601.601(d)(2) of this chapter) prescribing additional rules for applying the pooling methods authorized by this section to specific industries or to specific types of transactions.

(7) *Example.* The following example illustrates the rules of this paragraph (h):

Example. Pooling. (i) In the course of its business, W corporation enters into 3-year non-cancelable contracts that provide W the right to provide services to its customers. W generally pays certain amounts in the process of pursuing an agreement with a customer, including amounts paid to credit reporting agencies to verify the credit history of the potential customer and commissions paid to the independent sales agent who secures the agreement with the customer. In the case of agreements that W enters into with customers who are individuals, the agreements contain substantially similar terms and conditions and W typically pays between $100 and $200 in the process of pursuing each transaction. During 2005, W enters into agreements with 300 individuals. Also during 2005, W enters into an agreement with X corporation containing terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals. W pays certain amounts in the process of pursuing the agreement with X that W would not typically incur in the process of pursuing an agreement with its customers who are individuals. For example, W pays amounts to prepare and submit a bid for the agreement with X and amounts to travel to X's headquarters to make a sales presentation to X's management. In the aggregate, W pays $11,000 in the process of obtaining the agreement with X.

(ii) The agreements between W and its customers are agreements providing W the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Under paragraph (b)(1)(v) of this section, W must capitalize transaction costs paid to facilitate the creation of these agreements. Because W enters into at least 25 similar transactions during 2005, W may pool its transactions for purposes of determining whether its transaction costs are *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. W adopts a pooling method by establishing one or more pools of similar transactions and by using the pooling method to compute its taxable income beginning in its 2005 taxable year. If W adopts a pooling method, W must include all similar transactions in the pool. Under paragraph (h)(4) of this section, the transaction with X is not similar to the transactions W enters into with its customers who are individuals. While the agreement with X contains terms and conditions that are substantially similar to those contained in the agreements W enters into with its customers who are individuals, the transaction costs paid in the process of pursuing the agreement with X are reasonably expected to differ significantly from the average transaction costs attributable to transactions with its customers who are individuals. Accordingly, W may not include the transaction with X in the pool of transactions with customers who are individuals.

(i) [Reserved]

(j) *Application to accrual method taxpayers.* For purposes of this section, the terms *amount paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(k) *Treatment of related parties and indirect payments.* For purposes of this section, references to a party other than the taxpayer include persons related to that party and persons acting for or on behalf of that party (including persons to whom the taxpayer becomes obligated as a result of assuming a liability of that party). For this purpose, persons are related only if their relationship is described in section 267(b) or 707(b) or they are engaged in trades or businesses under common control within the meaning of section 41(f)(1). References to an amount paid to or by a party include an amount paid on behalf of that party.

(l) *Examples.* The rules of this section are illustrated by the following examples in which it is assumed that the Internal Revenue Service has not published guidance that requires capitalization under paragraph (b)(1)(iv) of this section (relating to amounts paid to create or enhance a future benefit that is identified in published guidance as an intangible for which capitalization is required):

Example 1. License granted by a governmental unit. (i) X corporation pays $25,000 to state R to obtain a license to sell alcoholic beverages in its restaurant. The license is valid indefinitely, provided X complies with all applicable laws regarding the sale of alcoholic beverages in state R. X pays its outside counsel $4,000 for legal services rendered in preparing the license application and otherwise representing X during the licensing process. In addition, X determines that $2,000 of salaries paid to its employees is allocable to services rendered by the employees in obtaining the license.

(ii) X's payment of $25,000 is an amount paid to a governmental unit to obtain a license granted by that agency, as described in paragraph (d)(5)(i) of this section. The right has an indefinite duration and constitutes an amortizable section 197 intangible. Accordingly, as provided in paragraph (f)(3) of this section, the provisions of paragraph (f) of this section (relating to the 12-month rule) do not apply to X's payment. X must capitalize its $25,000 payment to obtain the license from state R.

(iii) As provided in paragraph (e)(4) of this section, X is not required to capitalize employee compensation because such amounts are treated as amounts that do not facilitate the acquisition or creation of an intangible. Thus, X is not required to capitalize the $2,000 of employee compensation allocable to the transaction.

(iv) X's payment of $4,000 to its outside counsel is an amount paid to facilitate the creation of an intangible, as described in paragraph (e)(1)(i) of this section. Because X's transaction costs do not exceed $5,000, X's transaction costs are *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, X is not required to capitalize the $4,000 payment to its outside counsel under this section.

Example 2. Franchise agreement. (i) R corporation is a franchisor of income tax return preparation outlets. V corporation negotiates with R to obtain the right to operate an income tax return preparation outlet under a franchise from R. V pays an initial $100,000 franchise fee to R in exchange for the franchise agreement. In addition, V pays its outside counsel $4,000 to represent V during the negotiations with R. V also pays $2,000 to an industry consultant to advise V during the negotiations with R.

(ii) Under paragraph (d)(6)(i)(A) of this section, V's payment of $100,000 is an amount paid to another party to enter into an agreement with that party providing V the right to use tangible or intangible property. Accordingly, V must capitalize its $100,000 payment to R. The franchise agreement is a self-created amortizable section 197 intangible within the meaning of section 197(c). Accordingly, as provided in paragraph (f)(3) of this section, the 12-month rule contained in paragraph (f)(1) of this section does not apply.

(iii) V's payment of $4,000 to its outside counsel and $2,000 to the industry consultant are amounts paid to facilitate the creation of an intangible, as described in paragraph (e)(1)(i) of this section. Because V's aggregate transaction costs exceed $5,000, V's transaction costs are not *de minimis* within the meaning of paragraph (e)(4)(iii)(A) of this section. Accordingly, V must capitalize the $4,000 payment to its outside counsel and the $2,000 payment to the industry consultant under this section into the basis of the franchise, as provided in paragraph (g) of this section.

Example 3. Covenant not to compete. (i) On December 1, 2005, N corporation, a calendar year taxpayer, enters into a covenant not to compete with B, a key employee that is leaving the employ of N. The covenant not to compete is not entered into in connection with the acquisition of an interest in a trade or business. The covenant not to compete prohibits B from competing with N for a period of 9 months, beginning December 1, 2005. N pays B $25,000 in full consideration for B's agreement not to compete. In addition, N pays its outside counsel $6,000 to facilitate the creation of the covenant not to compete with B. N does not have a short taxable year in 2005 or 2006.

(ii) Under paragraph (d)(6)(i)(C) of this section, N's payment of $25,000 is an amount paid to another party to induce that party to enter into a covenant not to compete with N. However, because the covenant not to compete has a duration that does not extend beyond 12 months after the first date on which N realizes the rights attributable to its payment (*i.e.,* December 1, 2005) or beyond the end of the taxable year following the taxable year in which payment is made, the 12-month rule contained in paragraph (f)(1) of this section applies. Accordingly, N is not required to capitalize its $25,000 payment to B or its $6,000 payment to facilitate the creation of the covenant not to compete.

Example 4. Demand-side management. (i) X corporation, a public utility engaged in generating and distributing electrical energy, provides programs to its customers to promote energy conservation and energy efficiency. These programs are aimed at reducing electrical costs to X's customers, building goodwill with X's customers, and reducing X's future operating and capital costs. X provides these programs without obligating any of its customers participating in the programs to purchase power from X in the future. Under these programs, X pays a consultant to help industrial customers design energy-efficient manufacturing processes, to conduct ''energy efficiency audits'' that serve to identify for customers inefficiencies in their energy usage patterns, and to provide cash allowances to encourage residential customers to replace existing appliances with more energy efficient appliances.

(ii) The amounts paid by X to the consultant are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to the consultant are not required to be capitalized under this section. While the amounts may serve to reduce future operating and capital costs and create goodwill with customers, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 5. Business process re-engineering. (i) V corporation manufactures its products using a batch production system. Under this system, V continuously produces component parts of its various products and stockpiles these parts until they are needed in V's final assembly line. Finished goods are stockpiled awaiting orders from customers. V discovers that this process ties up significant amounts of V's capital in work-in-process and finished goods inventories. V hires B, a consultant, to advise V on improving the efficiency of its manufacturing operations. B recommends a complete re-engineering of V's manufacturing process to a process known as just-in-time manufacturing. Just-in-time manufacturing involves reconfiguring a manufacturing plant to a configuration of ''cells'' where each team in a cell performs the entire manufacturing process for a particular customer order, thus reducing inventory stockpiles.

(ii) V incurred three categories of costs to convert its manufacturing process to a just-in-time system. First, V paid B, a consultant, $250,000 in professional fees to implement the conversion of V's plant to a just-in-time system. Second, V paid C, a contractor, $100,000 to relocate and reconfigure V's manufacturing equipment from an assembly line layout to a configuration of cells. Third, V paid D, a consultant, $50,000 to train V's employees in the just-in-time manufacturing process.

(iii) The amounts paid by V to B, C, and D are not amounts to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amounts paid to B, C, and D are not required to be capitalized under this section. While the amounts produce long term benefits to V in the form of reduced inventory stockpiles, improved product quality, and increased efficiency, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 6. Defense of business reputation. (i) X, an investment adviser, serves as the fund manager of a money market investment fund. X, like its competitors in the industry, strives to maintain a constant net asset value for its money market fund of $1.00 per share. During 2005, in the course of managing the fund assets, X incorrectly predicts the direction of market interest rates, resulting in significant investment losses to the fund. Due to these significant losses, X is faced with the prospect of reporting a net asset value that is less than $1.00 per share. X is not aware of any investment adviser in its industry that has ever reported a net asset value for its money market fund of less than $1.00 per share. X is concerned that reporting a net asset value of less than $1.00 per share will significantly harm its reputation as an investment adviser, and could lead to litigation by shareholders. X decides to contribute $2,000,000 to the fund in order to raise the net asset value of the fund to $1.00 per share. This contribution is not a loan to the fund and does not give X any ownership interest in the fund.

(ii) The $2,000,000 contribution is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, the amount contributed to the fund is not required to be capitalized under this section. While the amount serves to protect the business reputation of the taxpayer and may protect the taxpayer from litigation by shareholders, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 7. Product launch costs. (i) R corporation, a manufacturer of pharmaceutical products, is required by law to obtain regulatory approval before selling its products. While awaiting regulatory approval on Product A, R pays to develop and implement a marketing strategy and an advertising campaign to raise consumer awareness of the purported need for Product A. R also pays to train health care professionals and other distributors in the proper use of Product A.

(ii) The amounts paid by R are not amounts paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, R is not required to capitalize these amounts under this section. While the amounts may benefit R by creating consumer demand for Product A and increasing awareness of Product A among distributors, these benefits, without more, are not intangibles for which capitalization is required under this section.

Example 8. Stocklifting costs. (i) N corporation is a wholesale distributor of Brand A aftermarket automobile replacement parts. In an effort to induce a retail automobile parts supply store to stock only Brand A parts, N offers to replace all of the store's inventory of other branded parts with Brand A parts, and to credit the store for its cost of other branded parts. The store is under no obligation to continue stocking Brand A parts or to purchase a minimum volume of Brand A parts from N in the future.

(ii) The amount paid by N as a credit to the store for the cost of other branded parts is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amount does not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, N is not required to capitalize the amount under this section. While the amount may create a hope or expectation by N that the store will continue to stock Brand A parts, this benefit, without more, is not an intangible for which capitalization is required under this section.

(iii) Alternatively, assume that N agrees to credit the store for its cost of other branded parts in exchange for the store's agreement to purchase all of its inventory requirements for such parts from N for a period of at least 3 years. The amount paid by N as a credit to the store for the cost of other branded parts is an amount paid to induce the store to enter into an agreement providing R the right to provide property. Accordingly, R must capitalize its payment.

Example 9. Package design costs. (i) Z corporation manufactures and markets personal care products. Z pays $100,000 to a consultant to develop a package design for Z's newest product, Product A. Z also pays a fee to a government agency to obtain trademark and copyright protection on certain elements of the package design. Z pays its outside legal counsel $10,000 for services rendered in preparing and filing the trademark and copyright applications and for other services rendered in securing the trademark and copyright protection.

(ii) The $100,000 paid by Z to the consultant for development of the package design is not an amount paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, as provided in paragraph (b)(3)(v) of this section, amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, Z is not required to capitalize the $100,000 payment under this section.

(iii) The amounts paid by Z to the government agency to obtain trademark and copyright protection are amounts paid to a government agency for a right granted by that agency. Accordingly, Z must capitalize the payment. In addition, the $10,000 paid by Z to its outside counsel is an amount paid to facilitate the creation of the trademark and copyright. Because the aggregate amounts paid to facilitate the transaction exceed $5,000, the amounts are not *de minimis* as defined in paragraph (e)(4)(iii)(A) of this section. Accordingly, Z must capitalize the $10,000 payment to its outside counsel under paragraph (b)(1)(v) of this section.

(iv) Alternatively, assume that Z acquires an existing package design for Product A as part of an acquisition of a trade or business that constitutes an applicable asset acquisition within the meaning of section 1060(c). Assume further that $100,000 of the consideration paid by N in the acquisition is properly allocable to the package design for Product A. Under paragraph (c)(1) of this section, Z must capitalize the $100,000 payment.

Example 10. Contract to provide services. (i) Q corporation, a financial planning firm, provides financial advisory services on a fee-only basis. During 2005, Q and several other financial planning firms submit separate bids to R corporation for a contract to become one of three providers of financial advisory services to R's employees. Q pays $2,000 to a printing company to develop and produce materials for its sales presentation to R's management. Q also pays $6,000 to travel to R's corporate headquarters to make the sales presentation, and $20,000 of salaries to its employees for services performed in preparing the bid and making the presentation to R's management. Q's bid is successful and Q enters into an agreement with R in

2005 under which Q agrees to provide financial advisory services to R's employees, and R agrees to pay Q's fee on behalf of each employee who chooses to utilize such services. R enters into similar agreements with two other financial planning firms, and R's employees may choose to use the services of any one of the three firms. Based on its past experience, Q reasonably expects to provide services to at least 5 percent of R's employees.

(ii) Q's agreement with R is not an agreement providing Q the right to provide services, as described in paragraph (d)(6)(i)(B) of this section. Under paragraph (d)(6)(iv) the agreement places no obligation on another person to request or pay for Q's services. Accordingly, Q is not required to capitalize any of the amounts paid in the process of pursuing the agreement with R.

Example 11. Mutual fund distributor. (i) D incurs costs to enter into a distribution agreement with M, a mutual fund. The initial term of the distribution agreement is two years, and afterwards must be approved annually by M. The distribution agreement can be terminated by either party on 60 days notice. Although distribution agreements are rarely terminated in the mutual fund industry, M is not economically compelled to continue D's distribution agreement. Under the distribution agreement, D has the exclusive right to sell shares of M and agrees to use its best efforts to solicit orders for the sale of shares of M. D sells shares in M directly to the general public as well as through brokers. When an investor places an order for M shares with a broker, D pays the broker a commission for selling the shares to the investor. Under the distribution agreement, D receives compensation from M in the form of 12b–1 fees (which equal a percentage of M's net asset value attributable to investors that have held their shares for up to 6 years) and contingent deferred sales charges (which are paid if the investor redeems the purchased shares within 6 years).

(ii) The distribution agreement is not an agreement providing D with the right to provide services, as described in paragraph (d)(6)(i)(B) of this section, because the distribution agreement can be terminated by M at will upon 60 days notice and M is not economically compelled to continue the distribution agreement. Accordingly, D is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraphs (b)(1)(ii) or (v) of this section. In addition, as provided in paragraph (b)(3)(ii) of this section, amounts paid to create an agreement are treated as amounts that do not create a separate and distinct intangible asset. Accordingly, D also is not required to capitalize the costs of creating (or facilitating the creation of) the distribution agreement under paragraph (b)(1)(iii) or (v) of this section.

(iii) Under paragraph (b)(3)(iii), the broker commissions paid by D in performing services under the distribution agreement do not create (or facilitate the creation of) a separate and distinct intangible asset. In addition, the broker commissions do not create an intangible described in paragraph (d) of this section. Accordingly, D is not required to capitalize the broker commissions under this section.

(m) *Amortization*. For rules relating to amortization of certain intangibles, see §1.167(a)–3.

(n) *Intangible interests in land*. [Reserved].

(o) *Effective date*. This section applies to amounts paid or incurred on or after December 31, 2003.

(p) *Accounting method changes*—(1) *In general*. A taxpayer seeking to change a method of accounting to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). For the taxpayer's first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and §601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Scope limitations*. Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3) *Section 481(a) adjustment*. With the exception of a change to a pooling method authorized by this section, the section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer's first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002. A taxpayer seeking to change to a pooling method authorized by this section on or after the effective date of these regulations

must change to the method using a cut-off method.

[T.D. 9107, 69 FR 446, Jan. 5, 2004]

§ 1.263(a)–5 Amounts paid or incurred to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions.

(a) *General rule.* A taxpayer must capitalize an amount paid to facilitate (within the meaning of paragraph (b) of this section) each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction:

(1) An acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition).

(2) An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of section 267(b) or 707(b) (*see* § 1.263(a)–4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of section 267(b) or 707(b) immediately after the acquisition).

(3) An acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise).

(4) A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in section 368 and distributions of stock by the taxpayer as described in section 355).

(5) A transfer described in section 351 or section 721 (whether the taxpayer is the transferor or transferee).

(6) A formation or organization of a disregarded entity.

(7) An acquisition of capital.

(8) A stock issuance.

(9) A borrowing. For purposes of this section, a borrowing means any issuance of debt, including an issuance of debt in an acquisition of capital or in a recapitalization. A borrowing also includes debt issued in a debt for debt exchange under § 1.1001–3.

(10) Writing an option.

(b) *Scope of facilitate*—(1) *In general.* Except as otherwise provided in this section, an amount is paid to facilitate a transaction described in paragraph (a) of this section if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction. An amount paid to another party in exchange for tangible or intangible property is not an amount paid to facilitate the exchange. For example, the purchase price paid to the target of an asset acquisition in exchange for its assets is not an amount paid to facilitate the acquisition. Similarly, the purchase price paid by an acquirer to the target's shareholders in exchange for their stock in a stock acquisition is not an amount paid to facilitate the acquisition of the stock. See § 1.263(a)–1, § 1.263(a)–2, and § 1.263(a)–4 for rules requiring capitalization of the purchase price paid to acquire property.

(2) *Ordering rules.* An amount paid in the process of investigating or otherwise pursuing both a transaction described in paragraph (a) of this section and an acquisition or creation of an intangible described in § 1.263(a)–4 is subject to the rules contained in this section, and not to the rules contained in § 1.263(a)–4. In addition, an amount required to be capitalized by § 1.263(a)–1, § 1.263(a)–2, or § 1.263(a)–4 does not facilitate a transaction described in paragraph (a) of this section.

(c) *Special rules for certain costs*—(1) *Borrowing costs.* An amount paid to facilitate a borrowing does not facilitate another transaction (other than the borrowing) described in paragraph (a) of this section.

(2) *Costs of asset sales.* An amount paid by a taxpayer to facilitate a sale of its assets does not facilitate another transaction (other than the sale) described in paragraph (a) of this section. For example, where a target corporation, in preparation for a merger with an acquiring corporation, sells assets that are not desired by the acquiring corporation, amounts paid to facilitate the sale of the unwanted assets are not required to be capitalized as amounts paid to facilitate the merger.

(3) *Mandatory stock distributions.* An amount paid in the process of investigating or otherwise pursuing a distribution of stock by a taxpayer to its shareholders does not facilitate a transaction described in paragraph (a) of this section if the divestiture of the stock (or of properties transferred to an entity whose stock is distributed) is required by law, regulatory mandate, or court order. A taxpayer is not required to capitalize (under this section or §1.263(a)–4) an amount paid to organize (or facilitate the organization of) an entity if the entity is organized solely to receive properties that the taxpayer is required to divest by law, regulatory mandate, or court order and if the taxpayer distributes the stock of the entity to its shareholders. A taxpayer also is not required to capitalize (under this section or §1.263(a)–4) an amount paid to transfer property to an entity if the taxpayer is required to divest itself of that property by law, regulatory mandate, or court order and if the stock of the recipient entity is distributed to the taxpayer's shareholders.

(4) *Bankruptcy reorganization costs.* An amount paid to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code by a taxpayer that is the debtor under the proceeding constitutes an amount paid to facilitate a reorganization within the meaning of paragraph (a)(4) of this section, regardless of the purpose for which the proceeding is instituted. For example, an amount paid to prepare and file a petition under Chapter 11, to obtain an extension of the exclusivity period under Chapter 11, to formulate plans of reorganization under Chapter 11, to analyze plans of reorganization formulated by another party in interest, or to contest or obtain approval of a plan of reorganization under Chapter 11 facilitates a reorganization within the meaning of this section. However, amounts specifically paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization under Chapter 11 that resolves tort liabilities of the taxpayer do not facilitate a reorganization within the meaning of paragraph (a)(4) of this section if the amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. In addition, an amount paid by the taxpayer to defend against the commencement of an involuntary bankruptcy proceeding against the taxpayer does not facilitate a reorganization within the meaning of paragraph (a)(4) of this section. An amount paid by the debtor to operate its business during a Chapter 11 bankruptcy proceeding is not an amount paid to institute or administer the bankruptcy proceeding and does not facilitate a reorganization. Such amount is treated in the same manner as it would have been treated had the bankruptcy proceeding not been instituted.

(5) *Stock issuance costs of open-end regulated investment companies.* Amounts paid by an open-end regulated investment company (within the meaning of section 851) to facilitate an issuance of its stock are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section unless the amounts are paid during the initial stock offering period.

(6) *Integration costs.* An amount paid to integrate the business operations of the taxpayer with the business operations of another does not facilitate a transaction described in paragraph (a) of this section, regardless of when the integration activities occur.

(7) *Registrar and transfer agent fees for the maintenance of capital stock records.* An amount paid by a taxpayer to a registrar or transfer agent in connection with the transfer of the taxpayer's capital stock does not facilitate a transaction described in paragraph (a) of this section unless the amount is paid

with respect to a specific transaction described in paragraph (a). For example, a taxpayer is not required to capitalize periodic payments to a transfer agent for maintaining records of the names and addresses of shareholders who trade the taxpayer's shares on a national exchange. By comparison, a taxpayer is required to capitalize an amount paid to the transfer agent for distributing proxy statements requesting shareholder approval of a transaction described in paragraph (a) of this section.

(8) *Termination payments and amounts paid to facilitate mutually exclusive transactions.* An amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in paragraph (a) of this section constitutes an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive. An amount paid to facilitate a transaction described in paragraph (a) of this section is treated as an amount paid to facilitate a second transaction described in paragraph (a) of this section only if the transactions are mutually exclusive.

(d) *Simplifying conventions*—(1) *In general.* For purposes of this section, employee compensation (within the meaning of paragraph (d)(2) of this section), overhead, and *de minimis* costs (within the meaning of paragraph (d)(3) of this section) are treated as amounts that do not facilitate a transaction described in paragraph (a) of this section.

(2) *Employee compensation*—(i) *In general.* The term *employee compensation* means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(ii) *Certain amounts treated as employee compensation.* For purposes of this section, a guaranteed payment to a partner in a partnership is treated as employee compensation. For purposes of this section, annual compensation paid to a director of a corporation is treated as employee compensation. For example, an amount paid to a director of a corporation for attendance at a regular meeting of the board of directors (or committee thereof) is treated as employee compensation for purposes of this section. However, an amount paid to the director for attendance at a special meeting of the board of directors (or committee thereof) is not treated as employee compensation. An amount paid to a person that is not an employee of the taxpayer (including the employer of the individual who performs the services) is treated as employee compensation for purposes of this section only if the amount is paid for secretarial, clerical, or similar administrative support services (other than services involving the preparation and distribution of proxy solicitations and other documents seeking shareholder approval of a transaction described in paragraph (a) of this section). In the case of an affiliated group of corporations filing a consolidated federal income tax return, a payment by one member of the group to a second member of the group for services performed by an employee of the second member is treated as employee compensation if the services provided by the employee are provided at a time during which both members are affiliated.

(3) *De minimis costs*—(i) *In general.* The term *de minimis costs* means amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section if, in the aggregate, the amounts do not exceed $5,000 (or such greater amount as may be set forth in published guidance). If the amounts exceed $5,000 (or such greater amount as may be set forth in published guidance), none of the amounts are *de minimis costs* within the meaning of this paragraph (d)(3). For purposes of this paragraph (d)(3), an amount paid in the form of property is valued at its fair market value at the time of the payment.

(ii) *Treatment of commissions.* The term *de minimis costs* does not include commissions paid to facilitate a transaction described in paragraph (a) of this section.

(4) *Election to capitalize.* A taxpayer may elect to treat employee compensation, overhead, or *de minimis costs* paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a) of this section as amounts that facilitate the transaction. The election is made separately for each transaction and applies to employee compensation, overhead, or *de minimis costs,* or to any combination thereof. For example, a taxpayer may elect to treat overhead and *de minimis costs,* but not employee compensation, as amounts that facilitate the transaction. A taxpayer makes the election by treating the amounts to which the election applies as amounts that facilitate the transaction in the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (d)(4) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(e) *Certain acquisitive transactions*—(1) *In general.* Except as provided in paragraph (e)(2) of this section (relating to inherently facilitative amounts), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction (as described in paragraph (e)(3) of this section) facilitates the transaction within the meaning of this section only if the amount relates to activities performed on or after the earlier of—

(i) The date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or

(ii) The date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. In the case of a transaction that does not require authorization or approval of the taxpayer's board of directors (or appropriate governing officials in the case of a taxpayer that is not a corporation) the date determined under this paragraph (e)(1)(ii) is the date on which the acquirer and the target execute a binding written contract reflecting the terms of the transaction.

(2) *Exception for inherently facilitative amounts.* An amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(1) of this section. An amount is inherently facilitative if the amount is paid for—

(i) Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;

(ii) Structuring the transaction, including negotiating the structure of the transaction and obtaining tax advice on the structure of the transaction (for example, obtaining tax advice on the application of section 368);

(iii) Preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement);

(iv) Obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;

(v) Obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs, and costs to promote the transaction to shareholders); or

(vi) Conveying property between the parties to the transaction (for example, transfer taxes and title registration costs).

(3) *Covered transactions.* For purposes of this paragraph (e), the term *covered transaction* means the following transactions:

(i) A taxable acquisition by the taxpayer of assets that constitute a trade or business.

(ii) A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b).

(iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

(f) *Documentation of success-based fees*—An amount paid that is contingent on the successful closing of a transaction described in paragraph (a) of this section is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes. For purposes of this paragraph (f), documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify—

(1) The various activities performed by the service provider;

(2) The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;

(3) Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and

(4) The name, business address, and business telephone number of the service provider.

(g) *Treatment of capitalized costs*—(1) *Tax-free acquisitive transactions*. [Reserved]

(2) *Taxable acquisitive transactions*—(i) *Acquirer*. In the case of an acquisition, merger, or consolidation that is not described in section 368, an amount required to be capitalized under this section by the acquirer is added to the basis of the acquired assets (in the case of a transaction that is treated as an acquisition of the assets of the target for federal income tax purposes) or the acquired stock (in the case of a transaction that is treated as an acquisition of the stock of the target for federal income tax purposes).

(ii) *Target*—(A) *Asset acquisition*. In the case of an acquisition, merger, or consolidation that is not described in section 368 and that is treated as an acquisition of the assets of the target for federal income tax purposes, an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets.

(B) *Stock acquisition*. [Reserved]

(3) *Stock issuance transactions*. [Reserved]

(4) *Borrowings*. For the treatment of amounts required to be capitalized under this section with respect to a borrowing, see § 1.446–5.

(5) *Treatment of capitalized amounts by option writer*. An amount required to be capitalized by an option writer under paragraph (a)(10) of this section is not currently deductible under section 162 or 212. Instead, the amount required to be capitalized generally reduces the total premium received by the option writer. However, other provisions of law may limit the reduction of the premium by the capitalized amount (for example, if the capitalized amount is never deductible by the option writer).

(h) *Application to accrual method taxpayers*. For purposes of this section, the terms *amount paid* and *payment* mean, in the case of a taxpayer using an accrual method of accounting, a liability incurred (within the meaning of § 1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(i) [Reserved]

(j) *Coordination with other provisions of the Internal Revenue Code.* Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or regulations thereunder.

(k) *Treatment of indirect payments.* For purposes of this section, references to an amount paid to or by a party include an amount paid on behalf of that party.

(l) *Examples.* The following examples illustrate the rules of this section:

Example 1. Costs to facilitate. Q corporation pays its outside counsel $20,000 to assist Q in registering its stock with the Securities and Exchange Commission. Q is not a regulated investment company within the meaning of section 851. Q's payments to its outside counsel are amounts paid to facilitate the issuance of stock. Accordingly, Q must capitalize its $20,000 payment under paragraph (a)(8) of this section (whether incurred before or after the issuance of the stock and whether or not the registration is productive of equity capital).

Example 2. Costs to facilitate. Q corporation seeks to acquire all of the outstanding stock of Y corporation. To finance the acquisition, Q must issue new debt. Q pays an investment banker $25,000 to market the debt to the public and pays its outside counsel $10,000 to prepare the offering documents for the debt. Q's payment of $35,000 facilitates a borrowing and must be capitalized under paragraph (a)(9) of this section. As provided in paragraph (c)(1) of this section, Q's payment does not facilitate the acquisition of Y, notwithstanding the fact that Q incurred the new debt to finance its acquisition of Y. See §1.446–5 for the treatment of Q's capitalized payment.

Example 3. Costs to facilitate. (i) Z agrees to pay investment banker B $1,000,000 for B's services in evaluating four alternative transactions ($250,000 for each alternative): An initial public offering; a borrowing of funds; an acquisition by Z of a competitor; and an acquisition of Z by a competitor. Z eventually decides to pursue a borrowing and abandons the other options.

(ii) The $250,000 payment to evaluate the possibility of a borrowing is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(9) of this section. Accordingly Z must capitalize that $250,000 payment to B. See §1.446–5 for the treatment of Z's capitalized payment.

(iii) The $250,000 payment to evaluate the possibility of an initial public offering is an amount paid in the process of investigating or otherwise pursuing a transaction described in paragraph (a)(8) of this section. Accordingly, Z must capitalize that $250,000 payment to B under this section. Because the borrowing and the initial public offering are not mutually exclusive transactions, the $250,000 is not treated as an amount paid to facilitate the borrowing. When Z abandons the initial public offering, Z may recover under section 165 the $250,000 paid to facilitate the initial public offering.

(iv) The $500,000 paid by Z to evaluate the possibilities of an acquisition of Z by a competitor and an acquisition of a competitor by Z are amounts paid in the process of investigating or otherwise pursuing transactions described in paragraphs (a) and (e)(3) of this section. Accordingly, Z is only required to capitalize under this section the portion of the $500,000 payment that relates to inherently facilitative activities under paragraph (e)(2) of this section or to activities performed on or after the date determined under paragraph (e)(1) of this section. Because the borrowing and the possible acquisitions are not mutually exclusive transactions, no portion of the $500,000 is treated as an amount paid to facilitate the borrowing. When Z abandons the acquisition transactions, Z may recover under section 165 any portion of the $500,000 that was paid to facilitate the acquisitions.

Example 4. Corporate acquisition. (i) On February 1, 2005, R corporation decides to investigate the acquisition of three potential targets: T corporation, U corporation, and V corporation. R's consideration of T, U, and V represents the consideration of three distinct transactions, any or all of which R might consummate and has the financial ability to consummate. On March 1, 2005, R enters into an exclusivity agreement with T and stops pursuing U and V. On July 1, 2005, R acquires all of the stock of T in a transaction described in section 368. R pays $1,000,000 to an investment banker and $50,000 to its outside counsel to conduct due diligence on T, U, and V; determine the value of T, U, and V; negotiate and structure the transaction with T; draft the merger agreement; secure shareholder approval; prepare SEC filings; and obtain the necessary regulatory approvals.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on T, U and V prior to March 1, 2005 (the date of the exclusivity agreement) are not amounts paid to facilitate the acquisition of the stock of T, U or V and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on T on and after March 1, 2005, are amounts paid to facilitate the acquisition of the stock of T and must be capitalized under paragraph (a)(2) of this section.

(iii) Under paragraph (e)(2) of this section, the amounts paid to determine the value of T, negotiate and structure the transaction with T, draft the merger agreement, secure shareholder approval, prepare SEC filings, and obtain necessary regulatory approvals are inherently facilitative amounts paid to facilitate the acquisition of the stock of T and must be capitalized, regardless of whether those activities occur prior to, on, or after March 1, 2005.

(iv) Under paragraph (e)(2) of this section, the amounts paid to determine the value of U and V are inherently facilitative amounts paid to facilitate the acquisition of U or V and must be capitalized. Because the acquisition of U, V, and T are not mutually exclusive transactions, the costs that facilitate the acquisition of U and V do not facilitate the acquisition of T. Accordingly, the amounts paid to determine the value of U and V may be recovered under section 165 in the taxable year that R abandons the planned mergers with U and V.

Example 5. Corporate acquisition; employee bonus. Assume the same facts as in *Example 4*, except R pays a bonus of $10,000 to one of its corporate officers who negotiated the acquisition of T. As provided by paragraph (d)(1) of this section, Y is not required to capitalize any portion of the bonus paid to the corporate officer.

Example 6. Corporate acquisition; integration costs. Assume the same facts as in *Example 4*, except that, before and after the acquisition is consummated, R incurs costs to relocate personnel and equipment, provide severance benefits to terminated employees, integrate records and information systems, prepare new financial statements for the combined entity, and reduce redundancies in the combined business operations. Under paragraph (c)(6) of this section, these costs do not facilitate the acquisition of T. Accordingly, R is not required to capitalize any of these costs under this section.

Example 7. Corporate acquisition; compensation to target's employees. Assume the same facts as in *Example 4*, except that, prior to the acquisition, certain employees of T held unexercised options issued pursuant to T's stock option plan. These options granted the employees the right to purchase T stock at a fixed option price. The options did not have a readily ascertainable value (within the meaning of §1.83–7(b)), and thus no amount was included in the employees' income when the options were granted. As a condition of the acquisition, T is required to terminate its stock option plan. T therefore agrees to pay its employees who hold unexercised stock options the difference between the option price and the current value of T's stock in consideration of their agreement to cancel their unexercised options. Under paragraph (d)(1) of this section, T is not required to capitalize the amounts paid to its employees. See section 83 for the treatment of amounts received in cancellation of stock options.

Example 8. Asset acquisition; employee compensation. N corporation owns tangible and intangible assets that constitute a trade or business. M corporation purchases all the assets of N in a taxable transaction. Under paragraph (a)(1) of this section, M must capitalize amounts paid to facilitate the acquisition of the assets of N. Under paragraph (d)(1) of this section, no portion of the salaries of M's employees who work on the acquisition are treated as facilitating the transaction.

Example 9. Corporate acquisition; retainer. Y corporation's outside counsel charges Y $60,000 for services rendered in facilitating the friendly acquisition of the stock of Y corporation by X corporation. Y has an agreement with its outside counsel under which Y pays an annual retainer of $50,000. Y's outside counsel has the right to offset amounts billed for any legal services rendered against the annual retainer. Pursuant to this agreement, Y's outside counsel offsets $50,000 of the legal fees from the acquisition against the retainer and bills Y for the balance of $10,000. The $60,000 legal fee is an amount paid to facilitate the acquisition of an ownership interest in Y as described in paragraph (a)(3) of this section. Y must capitalize the full amount of the $60,000 legal fee.

Example 10. Corporate acquisition; antitrust defense costs. On March 1, 2005, V corporation enters into an agreement with X corporation to acquire all of the outstanding stock of X. On April 1, 2005, federal and state regulators file suit against V to prevent the acquisition of X on the ground that the acquisition violates antitrust laws. V enters into a consent agreement with regulators on May 1, 2005, that allows the acquisition to proceed, but requires V to hold separate the business operations of X pending the outcome of the antitrust suit and subjects V to possible divestiture. V acquires title to all of the outstanding stock of X on June 1, 2005. After June 1, 2005, the regulators pursue antitrust litigation against V seeking rescission of the acquisition. V pays $50,000 to its outside counsel for services rendered after June 1, 2005, to defend against the antitrust litigation. V ultimately prevails in the antitrust litigation. V's costs to defend the antitrust litigation are costs to facilitate its acquisition of the stock of X under paragraph (a)(2) of this section and must be capitalized. Although title to the shares of X passed to V prior to the date V incurred costs to defend the antitrust litigation, the amounts paid by V are paid in the process of pursuing the acquisition of the stock of X because the acquisition was not complete until the antitrust litigation was ultimately resolved. V must capitalize the $50,000 in legal fees.

Example 11. Corporate acquisition; defensive measures. (i) On January 15, 2005, Y corporation, a publicly traded corporation, becomes the target of a hostile takeover attempt by Z corporation. In an effort to defend against the takeover, Y pays legal fees to seek an injunction against the takeover and investment banking fees to locate a potential "white knight" acquirer. Y also pays amounts to complete a defensive recapitalization, and pays $50,000 to an investment banker for a fairness opinion regarding Z's initial offer. Y's efforts to enjoin the takeover and locate a white knight acquirer are unsuccessful, and on March 15, 2005, Y's board of directors decides to abandon its defense against the takeover and negotiate with Z in an effort to obtain the highest possible price for its shareholders. After Y abandons its defense against the takeover, Y pays an investment banker $1,000,000 for a second fairness opinion and for services rendered in negotiating with Z.

(ii) The legal fees paid by Y to seek an injunction against the takeover are not amounts paid in the process of investigating or otherwise pursuing the transaction with Z. Accordingly, these legal fees are not required to be capitalized under this section.

(iii) The investment banking fees paid to search for a white knight acquirer do not facilitate an acquisition of Y by a white knight because none of Y's costs with respect to a white knight were inherently facilitative amounts and because Y did not reach the date described in paragraph (e)(1) of this section with respect to a white knight. Accordingly, these amounts are not required to be capitalized under this section.

(iv) The amounts paid by Y to investigate and complete the recapitalization must be capitalized under paragraph (a)(4) of this section.

(v) The $50,000 paid to the investment bankers for a fairness opinion during Y's defense against the takeover and the $1,000,000 paid to the investment bankers after Y abandons its defense against the takeover are inherently facilitative amounts with respect to the transaction with Z and must be capitalized under paragraph (a)(3) of this section.

Example 12. Corporate acquisition; acquisition by white knight. (i) Assume the same facts as in *Example 11*, except that Y's investment bankers identify three potential white knight acquirers: U corporation, V corporation, and W corporation. Y pays its investment bankers to conduct due diligence on the three potential white knight acquirers. On March 15, 2005, Y's board of directors approves a tentative acquisition agreement under which W agrees to acquire all of the stock of Y, and the investment bankers stop due diligence on U and V. On June 15, 2005, W acquires all of the stock of Y.

(ii) Under paragraph (e)(1) of this section, the amounts paid to conduct due diligence on U, V, and W prior to March 15, 2005 (the date of board of directors' approval) are not amounts paid to facilitate the acquisition of the stock of Y and are not required to be capitalized under this section. However, the amounts paid to conduct due diligence on W on and after March 15, 2005, facilitate the acquisition of the stock of Y and are required to be capitalized.

Example 13. Corporate acquisition; mutually exclusive costs. (i) Assume the same facts as in *Example 11*, except that Y's investment banker finds W, a white knight. Y and W execute a letter of intent on March 10, 2005. Under the terms of the letter of intent, Y must pay W a $10,000,000 break-up fee if the merger with W does not occur. On April 1, 2005, Z significantly increases the amount of its offer, and Y decides to accept Z's offer instead of merging with W. Y pays its investment banker $500,000 for inherently facilitative costs with respect to the potential merger with W. Y also pays its investment banker $2,000,000 for due diligence costs with respect to the potential merger with W, $1,000,000 of which relates to services performed on or after March 10, 2005.

(ii) Y's $500,000 payment for inherently facilitative costs and Y's $1,000,000 payment for due diligence activities performed on or after March 10, 2005 (the date the letter of intent with W is entered into) facilitate the potential merger with W. Because Y could not merge with both W and Z, under paragraph (c)(8) of this section the $500,000 and $1,000,000 payments also facilitate the transaction between Y and Z. Accordingly, Y must capitalize the $500,000 and $1,000,000 payments as amounts that facilitate the transaction with Z.

(iii) Similarly, because Y could not merge with both W and Z, under paragraph (c)(8) of this section the $10,000,000 termination payment facilitates the transaction between Y and Z. Accordingly, Y must capitalize the $10,000,000 termination payment as an amount that facilitates the transaction with Z.

Example 14. Break-up fee; transactions not mutually exclusive. N corporation and U corporation enter into an agreement under which U would acquire all the stock or all the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party $10,000,000. U decides to terminate the agreement and pays N $10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U's $10,000,000 payment does not facilitate U's acquisition of V. Accordingly, U is not required to capitalize the $10,000,000 payment under this section.

Example 15. Corporate reorganization; initial public offering. Y corporation is a closely held corporation. Y's board of directors authorizes an initial public offering of Y's stock to fund future growth. Y pays $5,000,000 in professional fees for investment banking services related to the determination of the offering price and legal services related to the development of the offering prospectus and the registration and issuance of stock. The investment banking and legal services are performed both before and after board authorization. Under paragraph (a)(8) of this section, the $5,000,000 is an amount paid to facilitate a stock issuance.

Example 16. Auction. (i) N corporation seeks to dispose of all of the stock of its wholly owned subsidiary, P corporation, through an auction process and requests that each bidder submit a non-binding purchase offer in the form of a draft agreement. Q corporation hires an investment banker to assist in the preparation of Q's bid to acquire P and to conduct a due diligence investigation of P. On July 1, 2005, Q submits its draft agreement. On August 1, 2005, N informs Q that it has accepted Q's offer, and presents Q with a signed letter of intent to sell all of the stock of P to Q. On August 5, 2005, Q's board of directors approves the terms of the transaction and authorizes Q to execute the letter of intent. Q executes a binding letter of intent with N on August 6, 2005.

(ii) Under paragraph (e)(1) of this section, the amounts paid by Q to its investment banker that are not inherently facilitative and that are paid for activities performed prior to August 5, 2005 (the date Q's board of directors approves the transaction) are not amounts paid to facilitate the acquisition of P. Amounts paid by Q to its investment banker for activities performed on or after August 5, 2005, and amounts paid by Q to its investment banker that are inherently facilitative amounts within the meaning of paragraph (e)(2) of this section are required to be capitalized under this section.

Example 17. Stock distribution. Z corporation distributes natural gas throughout state Y. The federal government brings an antitrust action against Z seeking divestiture of certain of Z's natural gas distribution assets. As a result of a court ordered divestiture, Z and the federal government agree to a plan of divestiture that requires Z to organize a subsidiary to receive the divested assets and to distribute the stock of the subsidiary to its shareholders. During 2005, Z pays $300,000 to various independent contractors for the following services: studying customer demand in the area to be served by the divested assets, identifying assets to be transferred to the subsidiary, organizing the subsidiary, structuring the transfer of assets to the subsidiary to qualify as a tax-free transaction to Z, and distributing the stock of the subsidiary to the stockholders. Under paragraph (c)(3) of this section, Z is not required to capitalize any portion of the $300,000 payments.

Example 18. Bankruptcy reorganization. (i) X corporation is the defendant in numerous lawsuits alleging tort liability based on X's role in manufacturing certain defective products. X files a petition for reorganization under Chapter 11 of the Bankruptcy Code in an effort to manage all of the lawsuits in a single proceeding. X pays its outside counsel to prepare the petition and plan of reorganization, to analyze adequate protection under the plan, to attend hearings before the Bankruptcy Court concerning the plan, and to defend against motions by creditors and tort claimants to strike the taxpayer's plan.

(ii) X's reorganization under Chapter 11 of the Bankruptcy Code is a reorganization within the meaning of paragraph (a)(4) of this section. Under paragraph (c)(4) of this section, amounts paid by X to its outside counsel to prepare, analyze or obtain approval of the portion of X's plan of reorganization that resolves X's tort liability do not facilitate the reorganization and are not required to be capitalized, provided that such amounts would have been treated as ordinary and necessary business expenses under section 162 had the bankruptcy proceeding not been instituted. All other amounts paid by X to its outside counsel for the services described above (including all amounts paid to prepare the bankruptcy petition) facilitate the reorganization and must be capitalized.

(m) *Effective date.* This section applies to amounts paid or incurred on or after December 31, 2003.

(n) *Accounting method changes*—(1) *In general.* A taxpayer seeking to change a method of accounting to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). For the taxpayer's first taxable year ending on or after December 31, 2003, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with this section, provided the taxpayer follows the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and §601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Scope limitations.* Any limitations on obtaining the automatic consent of the Commissioner do not apply to a taxpayer seeking to change to a method of accounting to comply with this section for its first taxable year ending on or after December 31, 2003.

(3) *Section 481(a) adjustment*. The section 481(a) adjustment for a change in method of accounting to comply with this section for a taxpayer's first taxable year ending on or after December 31, 2003 is determined by taking into account only amounts paid or incurred in taxable years ending on or after January 24, 2002.

[T.D. 9107, 69 FR 446, Jan. 5, 2004]

§ 1.263(a)–6 Election to deduct or capitalize certain expenditures.

(a) *In general*. Under certain provisions of the Internal Revenue Code (Code), taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) *Election provisions*. The sections referred to in paragraph (a) of this section include:

(1) Section 173 (circulation expenditures);

(2) Section 174 (research and experimental expenditures);

(3) Section 175 (soil and water conservation expenditures; endangered species recovery expenditures);

(4) Section 179 (election to expense certain depreciable business assets);

(5) Section 179A (deduction for cleanfuel vehicles and certain refueling property);

(6) Section 179B (deduction for capital costs incurred in complying with environmental protection agency sulfur regulations);

(7) Section 179C (election to expense certain refineries);

(8) Section 179D (energy efficient commercial buildings deduction);

(9) Section 179E (election to expense advanced mine safety equipment);

(10) Section 180 (expenditures by farmers for fertilizer);

(11) Section 181 (treatment of certain qualified film and television productions);

(12) Section 190 (expenditures to remove architectural and transportation barriers to the handicapped and elderly);

(13) Section 193 (tertiary injectants);

(14) Section 194 (treatment of reforestation expenditures);

(15) Section 195 (start-up expenditures);

(16) Section 198 (expensing of environmental remediation costs);

(17) Section 198A (expensing of qualified disaster expenses);

(18) Section 248 (organization expenditures of a corporation);

(19) Section 266 (carrying charges);

(20) Section 616 (development expenditures); and

(21) Section 709 (organization and syndication fees of a partnership).

(c) *Effective/applicability date*—(1) *In general*. This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (c)(2) and (c)(3) of this section, §1.263(a)–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014. For the effective dates of the enumerated election provisions, see those Code sections and the regulations under those sections.

(2) *Early application of this section*. A taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564*. A taxpayer may choose to apply §1.263(a)–6T as contained in TD 9564 (76 FR 81060) December 27, 2011, to taxable years beginning on or after January 1, 2012, and before January 1, 2014.

[T.D. 9636, 78 FR 57745, Sept. 19, 2013]

§ 1.263(b)–1 Expenditures for advertising or promotion of good will.

See §1.162–14 for the rules applicable to a corporation which has elected to capitalize expenditures for advertising or the promotion of good will under the provisions of section 733 or section 451 of the Internal Revenue Code of 1939, in computing its excess profits tax credit under Subchapter E, Chapter 2, or Subchapter D, Chapter 1, of the Internal Revenue Code of 1939.

§ 1.263(c)–1 Intangible drilling and development costs in the case of oil and gas wells.

For rules relating to the option to deduct as expenses intangible drilling and development costs in the case of oil and gas wells, see §1.612–4.

§ 1.263(e)–1 Expenditures in connection with certain railroad rolling stock.

(a) *Allowance of deduction*—(1) *Election*. Under section 263(e), for any taxable year beginning after December 31, 1969, a taxpayer may elect to treat certain expenditures paid or incurred during such taxable year as deductible repairs under section 162 or 212. This election applies only to expenditures described in paragraph (c) of this section in connection with the rehabilitation of a unit of railroad rolling stock (as defined in paragraph (b)(2) of this section) used by a domestic common carrier by railroad (as defined in paragraph (b) (3) and (4) of this section). However, an election under section 263(e) may not be made with respect to expenditures in connection with any unit of railroad rolling stock for which an election under section 263(f) and the regulations thereunder is in effect. An election made under section 263(e) is an annual election which may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer.

(2) *Special 20 percent rule*. Section 263(e) shall not apply if, under paragraph (d) of this section, expenditures paid or incurred during any period of 12 calendar months in connection with the rehabilitation of a unit exceed 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. However, section 263(e) does not constitute a limit on the deduction of expenditures for repairs which are deductible without regard to such section. Accordingly, amounts otherwise deductible as repairs will continue to be deductible even though such amounts exceed 20 percent of the basis of the unit of railroad rolling stock in the hands of the taxpayer.

(3) *Time and manner of making election*. (i) An election by a taxpayer under section 263(e) shall be made by a statement to that effect attached to its income tax return or amended income tax return for the taxable year for which the election is made if such return or amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year of election. An election under section 263(e) may be made with respect to one or more of the units of railroad rolling stock owned by the taxpayer. If an election is not made within the time and in the manner prescribed in this subparagraph, no election may be made (by the filing of an amended return or in any other manner) with respect to the taxable year.

(ii) If the taxpayer has filed a return on or before March 14, 1973, and has claimed a deduction under section 162 or 212 by reason of section 263(e), and if the taxpayer does not desire to make an election under section 263(e) for the taxable year with respect to which such return was filed, the taxpayer shall file an amended return for such taxable year on or before May 14, 1973, and shall pay any additional tax due for such year. The taxpayer shall also file an amended return for each taxable year which is affected by the filing of an amended return under the preceding sentence and shall pay any additional tax due for such year. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iii) If an election under section 263(e) was not made at the time the return for a taxable year was filed, and it is subsequently determined that an expenditure was erroneously treated as an expenditure which was not in connection with rehabilitation (as determined under paragraph (c) of this section), an election under section 263(e) may be made with respect to the unit of railroad rolling stock for which such expenditure was made for such taxable year, notwithstanding any provision in this subparagraph (3) to the contrary. Nothing in this subdivision shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(iv) The statement required by subdivision (i) of this subparagraph shall include the following information:

(*a*) The total number of units of railroad rolling stock with respect to which an election is being made under section 263(e).

(*b*) The aggregate basis (as defined in paragraph (b) (1) of this section) of the units described in (a) of this subdivision (iv), and

(*c*) The total deduction being claimed under section 263(e) for the taxable year.

(b) *Definitions*—(1) *Basis.* (i) In general, for purposes of section 263(e) the basis of a unit of railroad rolling stock shall be the adjusted basis of such unit determined without regard to the adjustments provided in paragraphs (1), (2), and (3) of section 1016(a) and section 1017. Thus, the basis of property would generally be its cost without regard to adjustments to basis such as for depreciation or for capital improvements. If the basis of a unit in the hands of a transferee is determined in whole or in part by reference to its basis in the hands of the transferor, for example, by reason of the application of section 362 (relating to basis to corporations), 374 (relating to gain or loss not recognized in certain railroad reorganizations), or 723 (relating to the basis of property contributed to a partnership), then the basis of such unit in the hands of the transferor for purposes of section 263(e) shall be its basis for purposes of section 263(e) in the hands of the transferee. Similarly, when the basis of a unit of railroad rolling stock in the hands of the taxpayer is determined in whole or in part by reference to the basis of another unit, for example, by reason of the application of the first sentence of section 1033(c) (relating to involuntary conversions), then the basis of the latter unit for purposes of section 263(e) shall be the basis for purposes of section 263(e) of the former unit. The question whether a capital expenditure in connection with a unit of railroad rolling stock results in the retirement of such unit and the creation of another unit of railroad rolling stock shall be determined without regard to rules under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(ii) For example, if a unit of railroad rolling stock has a cost to M of $10,000 and because of depreciation adjustments of $4,000 and capital expenditures of $3,000, such unit has an adjusted basis in the hands of M of $9,000, the basis for purposes of section 263(e) of such unit in the hands of M is $10,000. Further, if M transfers such unit to N in a transaction in which no gain or loss is recognized such as, for example, a transaction to which section 351(a) (relating to a transfer to a corporation controlled by the transferor) applies, the basis of such unit for purposes of section 263(e) is $10,000 in the hands of N.

(2) *Railroad rolling stock.* For purposes of this section, the term *unit* or *unit of railroad rolling stock* means a unit of transportation equipment the expenditures for which are of a type chargeable (or in the case of property leased to a domestic common carrier by railroad, would be chargeable) to the equipment investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission (49 CFR Part 1201), but only if (i) such unit exclusively moves on, moves under, or is guided by rail, and (ii) such unit is not a locomotive. Thus, for example, a unit of railroad rolling stock includes a box car, a gondola car, a passenger car, a car designed to carry truck trailers and containerized freight, a wreck crane, and a bunk car. However, such term does not include equipment which does not exclusively move on, move under, or is not exclusively guided by rail such as, for example, a barge, a tugboat, a container which is used on cars designed to carry containerized freight, a truck trailer, or an automobile. A locomotive is self-propelled equipment, the sole function of which is to push or pull railroad rolling stock. Thus, a self-propelled passenger or freight car is not a locomotive.

(3) *Domestic common carrier by railroad.* The term *domestic common carrier by railroad* means a railroad subject to regulation under Part I of the Interstate Commerce Act (49 U.S.C. 1 *et seq.*) or a railroad which would be subject to regulation under Part I of the Interstate Commerce Act if it were engaged in interstate commerce.

(4) *Use.* For purposes of this section, a unit of railroad rolling stock is not used by a domestic common carrier by railroad if it is owned by a person other than a domestic common carrier by railroad and (i) is exclusively used for transportation by the owner or (ii) is exclusively used for transportation by another person which is not a domestic

common carrier by railroad. Thus, for example, a unit of railroad rolling stock which is owned by a person which is not a domestic common carrier by railroad and is leased to a manufacturing company by the owner is not a unit of railroad rolling stock used by a domestic common carrier by railroad.

(c) *Expenditures considered in connection with rehabilitation.* For purposes of section 263(e) and this section all expenditures which would be properly chargeable to capital account but for the application of section 263 (e) or (f) shall be considered to be expenditures in connection with the rehabilitation of a unit of railroad rolling stock. Expenditures which are paid or incurred in connection with incidental repairs or maintenance of a unit of railroad rolling stock and which are deductible without regard to section 263 (e) or (f) shall not be included in any determination or computation under section 263(e) and shall not be treated as paid or incurred in connection with the rehabilitation of a unit of railroad rolling stock for purposes of section 263(e). The determination of whether an item would be, but for section 263 (e) or (f), properly chargeable to capital account shall be made in a manner consistent with the principles for classification of expenditures as between capital and expenses under the Internal Revenue Code. See, for example, §§ 1.162–4, 1.263(a)–1, 1.263(a)–2, and paragraph (a)(4) (ii) and (iii) of § 1.446–1. An expenditure shall be classified as capital or as expense without regard to its classification under the uniform system of accounts prescribed by the Interstate Commerce Commission.

(d) *20-percent limitation*—(1) *In general.* No expenditures in connection with the rehabilitation of a unit of railroad rolling stock shall be treated as a deductible repair by reason of an election under section 263(e) if, during any period of 12 calendar months in which the month the expenditure is included falls, all such expenditures exceed an amount equal to 20 percent of the basis (as defined in paragraph (b)(1) of this section) of such unit in the hands of the taxpayer. All such expenditures shall be included in the computation of the 20-percent limitation even if such expenditures were deducted under section 263(f) in either the preceding or succeeding taxable year. Solely for purposes of the 20-percent limitation in this paragraph, such expenditures shall be deemed to be included in the month in which a rehabilitation of the unit of railroad rolling stock is completed. For the requirement that expenditures treated as repairs solely by reason of an election under section 263(e) be deducted in the taxable year paid or incurred, see paragraph (a) of this section.

(2) *12-month period.* For purposes of this section, any period of 12 calendar months shall consist of any 12 consecutive calendar months except that calendar months prior to the calendar month of January 1970 shall not be included in determining such period.

(3) *Period for certain corporate acquisitions.* If a unit of railroad rolling stock to which section 263(e) applies is sold, exchanged, or otherwise disposed of in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor (see paragraph (b)(1) of this section), calendar months during which such unit is in the hands of the transferor and in the hands of such transferee shall both be included in the calendar months used by the transferor and the transferee to determine any period of 12 calendar months for purposes of section 263(e).

(4) *Deduction allowed in year paid or incurred.* If, based on the information available when the income tax return for a taxable year is filed, an expenditure paid or incurred in such taxable year would be deductible by reason of the application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in subparagraph (1) of this paragraph will be exceeded, the expenditure shall be deducted for such taxable year. If by reason of the application of such 20-percent limitation it is subsequently determined that such expenditure is not deductible as a repair, an amended return shall be filed for the year in which such deduction was treated as a deductible repair and additional tax, if any, for such year shall be paid. Appropriate adjustment with respect to the

taxpayer's tax liability for any other affected year shall be made. Nothing in this subparagraph shall be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(e) *Recordkeeping requirements*—(1) *In general.* Such records as will enable the accurate determination of the expenditures which may be subject to the treatment provided in section 263(e) shall be maintained. No deduction shall be allowed under section 162 or 212 by reason of section 263(e) with respect to a unit unless the taxpayer substantiates by adequate records that expenditures in connection with such unit of railroad rolling stock meet the requirements and limitations of this section.

(2) *Separate records.* A separate section 263(e) record shall be maintained for each unit with respect to which an election under section 263(e) is made. Such record shall:

(i) Identify the unit,

(ii) State the basis (as defined in paragraph (b)(1) of this section) and the date of acquisition of the unit,

(iii) Enumerate for each unit the amount of all expenditures incurred in connection with rehabilitation of such unit which would, but for section 263 (e) or (f), be properly chargeable to capital account (including expenditures incurred by the taxpayer in connection with rehabilitation of such unit undertaken by a person other than the taxpayer) regardless of whether such expenditures during any 12-month period exceed 20 percent of the basis of such unit,

(iv) Describe the nature of the work in connection with each expenditure, and

(v) Specify the calendar month in which the rehabilitation is completed and the taxable year in which each expenditure is paid or incurred.

A section 263(e) record need only be prepared for a unit of railroad rolling stock for the period beginning on the first day of the eleventh calendar month immediately preceding the month in which the rehabilitation of such unit is completed and ending on the last day of the eleventh calendar month immediately succeeding such month. No section 263(e) record need be prepared for calendar months before January 1970.

(3) *Records for certain expenditures:* Expenditures determined to be incidental repairs and maintenance (referred to in paragraph (c) of this section) shall not be entered in the section 263(e) record. However, each taxpayer shall maintain records to reflect that such expenditures are properly deductible.

(4) *Convenience rule.* In general, expenditures and information maintained in compliance with subparagraphs (1) and (2) of this paragraph shall be recorded in the section 263(e) record of the specific unit with respect to which such expenditures are incurred. However, when a group of units of the same type are rehabilitated in a single project and the expenditure for each unit in the project will approximate the average expenditure per unit for the project, expenditures for the project may be aggregated without regard to the unit in the project with respect to which each expenditure is connected, and an amount equal to the aggregate expenditures for the project divided by the number of units in the project may be entered in the section 263(e) account of each unit in the project.

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

Example 1. M Corporation, a domestic common carrier by railroad, uses the calendar year as its taxable year. M owns and uses several gondola cars to which an election under section 263(e) applies for its taxable years 1970–1972. Gondola car No.1 has a basis (defined in paragraph (b)(1) of this section) of $10,000. No expenditures properly chargeable to the section 263(e) record are made on gondola car No. 1 in 1970 and 1971, except in January 1971. In January 1971, M at a cost of $1,500 performed rehabilitation work on gondola car No. 1. Such amount was properly entered in the section 263(e) record for gondola car No.1. Since the expenditures in such record do not exceed an amount equal to 20 percent of the basis of gondola car No. 1 ($2,000) during any period of 12 calendar months in which January 1971 falls, the expenditures during January 1971 shall be treated as a deductible expense regardless of what the treatment would have been if section 263(e) had not been enacted.

Example 2. Assume the same facts as in *Example 1.* Assume further that for 1970, 1971, and 1972, only the following expenditures in connection with rehabilitation which would, but for section 263(e), be properly chargeable to capital account were deemed included for gondola car No. 2:

(a) December 1970	$1,500
(b) November 1971	600
(c) December 1971	400
(d) January 1972	1,050

Assume further that gondola car No. 2 has a basis (as defined in paragraph (b) (1) of this section) equal to $10,000, that M files its tax return by September 15 following each taxable year, and that each rehabilitation was completed in the month in which expenditures in connection with it were incurred. Any expenditures in connection with each gondola car (No. 1 or No. 2) have no effect on the treatment of expenditures in connection with the other gondola car. With respect to gondola car No. 2, the expenditures of December 1970 are treated as deductible repairs at the time M's income tax return for 1970 is filed because, based on the information available when the income tax return for 1970 is filed, such expenditure would be deductible by reason of application of section 263(e) but for the fact that it cannot be established whether the 20-percent limitation in paragraph (d)(1) of this section will be exceeded. Nevertheless, because such expenditures during the period of 12 calendar months including calendar months December 1970 and November 1971 exceed $2,000, the December 1970 rehabilitation expenditures are not subject to the provisions of section 263(e). Because such rehabilitation expenditures during the period of 12 calendar months including calendar months February 1971 and January 1972 exceed $2,000, rehabilitation expenditures in 1971 are not subject to the provisions of section 263(e). Similarly, the 1972 rehabilitation expenditures are not subject to the provisions of section 263(e).

[T.D. 7257, 38 FR 4255, Feb. 12, 1973]

§ 1.263(f)–1 Reasonable repair allowance.

(a) For rules regarding the election of the repair allowance authorized by section 263(f), the definition of repair allowance property, and the conditions under which an election may be made, see paragraphs (d) (2) and (f) of § 1.167(a)–11. An election may be made under this section for a taxable year only if the taxpayer makes an election under § 1.167(a)–11 for such taxable year.

(Sec. 263(f), 85 Stat. 509 (26 U.S.C. 263))

[T.D. 7272, 38 FR 9986, Apr. 23, 1973; 38 FR 12919, May 17, 1973, as amended by T.D. 7593, 44 FR 5421, Jan. 26, 1979]

§ 1.263A–0 Outline of regulations under section 263A.

This section lists the paragraphs in §§ 1.263A–1 through 1.263A–4 and §§ 1.263A–7 through 1.263A–15 as follows:

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(C) Centralized payroll services.
(D) Centralized data processing services.
(E) Engineering and design services.
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(v) Accounting method change.
(h) Simplified service cost method.
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(8) De minimis rule.
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(i) [Reserved]
(j) Exemption for certain small business taxpayers.
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(4) Materials and supplies.
(5) Definitions of section 471 costs and additional section 263A costs.
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§ 1.263A–2 Rules Relating to Property Produced by the Taxpayer.

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(ii) Pre-production costs.
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(ii) Definitions.
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(B) Pre-production absorption ratio.
(*1*) Pre-production additional section 263A costs.
(*2*) Pre-production section 471 costs.
(C) Pre-production section 471 costs remaining on hand at year end.
(D) Production absorption ratio.
(*1*) Production additional section 263A costs.
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(*3*) Production section 471 costs.
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(F) Costs allocated to property sold.
(iii) Allocable mixed service costs.
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(B) Taxpayer using the simplified service cost method.
(C) De minimis rule.
(iv) LIFO taxpayers electing the modified simplified production method.
(A) In general.
(B) LIFO increment.
(*1*) In general.
(*2*) Combined absorption ratio defined.
(C) LIFO decrement.
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(vi) Examples.
(4) Modified simplified production method with historic absorption ratio election.
(i) In general.
(ii) Operating rules and definitions.
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(iv) Extension of qualifying period.
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(d) Additional simplified methods for producers.
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§ 1.263A–3 Rules Relating to Property Acquired for Resale

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(i) In general.
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(i) In general.
(ii) Resellers with de minimis production activities.
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(2) Costs attributable to purchasing, handling, and storage.
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(B) Example.
(4) Handling costs.
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(v) Transportation costs.
(vi) Costs not considered handling costs.
(A) Distribution costs.
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(i) In general.
(ii) Definitions.
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(B) Dual-function storage facility allocation ratio.
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(*2*) Illustration of ratio allocation.
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(C) De minimis 90–10 rule for dual-function storage facilities.
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(d) Simplified resale method.
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(2) Eligible property.
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(A) In general.
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(D) Storage and handling costs absorption ratio.
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(4) Simplified resale method with historic absorption ratio election.
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(ii) Operating rules and definitions.
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(*1*) In general.
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(A) Reporting.
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(vi) Example.
(5) Additional simplified methods for resellers.
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§ 1.263A–4 Rules for property produced in a farming business.

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(3) Exemption for certain small business taxpayers.
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(A) In general.
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(C) Actual preproductive period.
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(C) Allocation of costs between animal and first yield.
(c) Inventory methods.
(1) In general.
(2) Available for property used in a trade or business.
(3) Exclusion of property to which section 263A does not apply.
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(1) Introduction.
(2) Availability of the election.
(3) Time and manner of making the election.
(i) Automatic election.
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(i) Section 1245 treatment.
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(iii) Related person.
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(e) Exception for certain costs resulting from casualty losses.
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(f) Change in method of accounting.
(1) Effective date.
(2) Change in method of accounting.
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(1) In general.
(2) Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).

§ 1.263A–7 Changing a method of accounting under section 263A.

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(1) Purpose.
(2) Taxpayers that adopt a method of accounting under section 263A.
(3) Taxpayers that change a method of accounting under section 263A.
(4) Applicability dates.
(i) In general.
(ii) Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).
(5) Definition of change in method of accounting.
(b) Rules applicable to a change in method of accounting.
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(B) Exceptions to the general ordering rule.
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(A) Need for a new base year.
(*1*) Facts and circumstances revaluation method used.
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(*i*) Simplified method not used.
(*ii*) Simplified method used.
(B) Computing a new base year.
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(1) Need for adjustments.
(2) Revaluing beginning inventory.
(i) In general.
(ii) Methods to revalue inventory.
(iii) Facts and circumstances revaluation method.
(A) In general.
(B) Exception.
(C) Estimates and procedures allowed.
(D) Use by dollar-value LIFO taxpayers.
(E) Examples.
(iv) Weighted average method.
(A) In general.
(B) Weighted average method for FIFO taxpayers.
(*1*) In general.
(*2*) Example.
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(*1*) In general.
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(D) Adjustments to inventory costs from prior years.
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(A) In general.
(B) Consecutive year requirement.
(C) Example.
(D) Short taxable years.
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(*1*) In general.
(*2*) Examples of restatement adjustment procedure.
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(i) Revaluing intercompany transactions.
(ii) Example.
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(4) Anti-abuse rule.
(i) In general.

(ii) Deemed avoidance of this section.
(A) Scope.
(B) General rule.
(iii) Election to use transferor's LIFO layers.
(iv) Tax avoidance intent not required.
(v) Related corporation.
(d) Non-inventory property.
(1) Need for adjustments.
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§ 1.263A–8 Requirement to capitalize interest.

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(3) Methods of accounting under section 263A(f).
(4) Special definitions.
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(2) Special rules.
(i) Application of thresholds.
(ii) Relevant activities and costs.
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(3) Excluded property.
(4) De minimis rule.
(i) In general.
(ii) Determination of total production expenditures.
(c) Definition of real property.
(1) In general.
(2) Unsevered natural products of land.
(3) Inherently permanent structures.
(4) Machinery.
(i) Treatment.
(ii) Certain factors not determinative.
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(1) Definition of produce.
(2) Property produced under a contract.
(i) Customer.
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(iii) Definition of a contract.
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(A) Customer.
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(3) Improvements to existing property.
(i) In general.
(ii) Real property.
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§ 1.263A–9 The avoided cost method.

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(2) Overview.
(i) In general.
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(4) Definition of eligible debt.
(b) Traced debt amount.
(1) General rule.
(2) Identification and definition of traced debt.
(3) Example.
(c) Excess expenditure amount.
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(2) Interest required to be capitalized.
(3) Example.
(4) Treatment of interest subject to a deferral provision.
(5) Definitions.
(i) Nontraced debt.
(A) Defined.
(B) Example.
(ii) Average excess expenditures.
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(B) Example.
(iii) Weighted average interest rate.
(A) Determination of rate.
(B) Interest incurred on nontraced debt.
(C) Average nontraced debt.
(D) Special rules if taxpayer has no nontraced debt or rate is contingent.
(6) Examples.
(7) Special rules where the excess expenditure amount exceeds incurred interest.
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(ii) Application of related person rules to average excess expenditures.
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(d) Election not to trace debt.
(1) General rule.
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(e) Election to use external rate.
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(2) Eligible taxpayer.
(f) Selection of computation period and measurement dates and application of averaging conventions.
(1) Computation period.
(i) In general.
(ii) Method of accounting.
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(i) In general.
(ii) Measurement period.
(iii) Measurement dates on which accumulated production expenditures must be taken into account.
(iv) More frequent measurement dates.
(3) Examples.
(g) Special rules.
(1) Ordering rules.
(i) Provisions preempted by section 263A(f).
(ii) Deferral provisions applied before this section.
(2) Application of section 263A(f) to deferred interest.
(i) In general.
(ii) Capitalization of deferral amount.
(iii) Deferred capitalization.
(iv) Substitute capitalization.
(A) General rule.

(B) Capitalization of amount carried forward.
(C) Method of accounting.
(v) Examples.
(3) Simplified inventory method.
(i) In general.
(ii) Segmentation of inventory.
(A) General rule.
(B) Example.
(iii) Aggregate interest capitalization amount.
(A) Computation period and weighted average interest rate.
(B) Computation of the tentative aggregate interest capitalization amount.
(C) Coordination with other interest capitalization computations.
(*1*) In general.
(*2*) Deferred interest.
(*3*) Other coordinating provisions.
(D) Treatment of increases or decreases in the aggregate interest capitalization amount.
(E) Example.
(iv) Method of accounting.
(4) Financial accounting method disregarded.
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(i) General rule.
(ii) Special rule for consolidated group with limited outside borrowing.
(iii) Example.
(6) Notional principal contracts and other derivatives. [Reserved]
(7) 15-day repayment rule.

§ 1.263A–10 Unit of property.

(a) In general.
(b) Units of real property.
(1) In general.
(2) Functional interdependence.
(3) Common features.
(4) Allocation of costs to unit.
(5) Treatment of costs when a common feature is included in a unit of real property.
(i) General rule.
(ii) Production activity not undertaken on benefitted property.
(A) Direct production activity not undertaken.
(*1*) In general.
(*2*) Land attributable to a benefitted property.
(B) Suspension of direct production activity after clearing and grading undertaken.
(*1*) General rule.
(*2*) Accumulated production expenditures.
(iii) Common feature placed in service before the end of production of a benefitted property.
(iv) Benefitted property sold before production completed on common feature.
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(6) Examples.
(c) Units of tangible personal property.
(d) Treatment of installations.

§ 1.263A–11 Accumulated production expenditures.

(a) General rule.
(b) When costs are first taken into account.
(1) In general.
(2) Dedication rule for materials and supplies.
(c) Property produced under a contract.
(1) Customer.
(2) Contractor.
(d) Property used to produce designated property.
(1) In general.
(2) Example.
(3) Excluded equipment and facilities.
(e) Improvements.
(1) General rule.
(2) De minimis rule.
(f) Mid-production purchases.
(g) Related person costs.
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§ 1.263A–12 Production period.

(a) In general.
(b) Related person activities.
(c) Beginning of production period.
(1) In general.
(2) Real property.
(3) Tangible personal property.
(d) End of production period.
(1) In general.
(2) Special rules.
(3) Sequential production or delivery.
(4) Examples.
(e) Physical production activities.
(1) In general.
(2) Illustrations.
(f) Activities not considered physical production.
(1) Planning and design.
(2) Incidental repairs.
(g) Suspension of production period.
(1) In general.
(2) Special rule.
(3) Method of accounting.
(4) Example.

§ 1.263A–13 Oil and gas activities.

(a) In general.
(b) Generally applicable rules.
(1) Beginning of production period.
(i) Onshore activities.
(ii) Offshore activities.
(2) End of production period.
(3) Accumulated production expenditures.
(i) Costs included.
(ii) Improvement unit.
(c) Special rules when definite plan not established.
(1) In general.
(2) Oil and gas units.
(i) First productive well unit.

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§ 1.263A–1 Uniform capitalization of costs.

(a) *Introduction*—(1) *In general.* The regulations under §§ 1.263A–1 through 1.263A–6 provide guidance to taxpayers that are required to capitalize certain costs under section 263A. These regulations generally apply to all costs required to be capitalized under section 263A except for interest that must be capitalized under section 263A(f) and the regulations thereunder. Statutory or regulatory exceptions may provide that section 263A does not apply to certain activities or costs; however, those activities or costs may nevertheless be subject to capitalization requirements under other provisions of the Internal Revenue Code and regulations.

(2) *Applicability dates.* (i) In general, this section and §§ 1.263A–2 and 1.263A–3 apply to costs incurred in taxable years beginning after December 31, 1993. In the case of property that is inventory in the hands of the taxpayer, however, these sections are applicable for taxable years beginning after December 31, 1993. The small business taxpayer exception described in paragraph (b)(1) of this section and set forth in paragraph (j) of this section is applicable for taxable years beginning after December 31, 2017. Changes in methods of accounting necessary as a result of the rules in this section and §§ 1.263A–2 and 1.263A–3 must be made under terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of § 1.263A–7 must be applied in revaluing inventory property.

(ii) For taxable years beginning before January 1, 1994, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A. For purposes of this paragraph (a)(2)(iii), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1994. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(3) *General scope*—(i) *Property to which section 263A applies.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to—

(A) Real property and tangible personal property produced by the taxpayer; and

(B) Real property and personal property described in section 1221(1), which is acquired by the taxpayer for resale.

(ii) *Property produced.* Taxpayers that produce real property and tangible personal property (producers) must capitalize all the direct costs of producing the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(i) and (3) of this section), regardless of whether the property is sold or used in the taxpayer's trade or business. See § 1.263A–2 for rules relating to producers.

(iii) *Property acquired for resale.* Retailers, wholesalers, and other taxpayers that acquire property described in section 1221(1) for resale (resellers) must capitalize the direct costs of acquiring the property and the property's properly allocable share of indirect costs (described in paragraphs (e)(2)(ii) and (3) of this section). See § 1.263A–3 for rules relating to resellers. See also section 263A(b)(2)(B), which excepts from section 263A personal property acquired for resale by a small reseller.

(iv) *Inventories valued at market.* Section 263A does not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For purposes of this paragraph (a)(3)(iv), the term fair market value means the price at which the taxpayer sells its inventory to its customers (e.g., as in the market value definition provided in §1.471–4(b)) less, if applicable, the direct cost of disposing of the inventory. However, section 263A does apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost. See §§1.471–4 and 1.471–5.

(v) *Property produced in a farming business.* Section 263A generally requires taxpayers engaged in a farming business to capitalize certain costs. See sections 263A(d) and 263A(e) and §1.263A–4 for rules relating to taxpayers engaged in a farming business.

(vi) *Creative property.* Section 263A generally requires taxpayers engaged in the production and resale of creative property to capitalize certain costs.

(vii) *Property produced or property acquired for resale by foreign persons.* Section 263A generally applies to foreign persons.

(b) *Exceptions*— (1) *Small business taxpayers.* For taxable years beginning after December 31, 2017, see section 263A(i) and paragraph (j) of this section for an exemption for certain small business taxpayers from the requirements of section 263A.

(2) *Long-term contracts.* Except for certain home construction contracts described in section 460(e)(1), section 263A does not apply to any property produced by the taxpayer pursuant to a long-term contract as defined in section 460(f), regardless of whether the taxpayer uses an inventory method to account for such production.

(3) *Costs incurred in certain farming businesses.* See section 263A(d) for an exception for costs paid or incurred in certain farming businesses. See §1.263A–4 for specific rules relating to taxpayers engaged in the trade or business of farming.

(4) *Costs incurred in raising, harvesting, or growing timber.* See section 263A(c)(5) for an exception for costs paid or incurred in raising, harvesting, or growing timber and certain ornamental trees. See §1.263A–4, however, for rules relating to taxpayers producing certain trees to which section 263A applies.

(5) *Qualified creative expenses.* See section 263A(h) for an exception for qualified creative expenses paid or incurred by certain free-lance authors, photographers, and artists.

(6) *Certain not-for-profit activities.* See section 263A(c)(1) for an exception for property produced by a taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit. This exception does not apply, however, to property produced by an exempt organization in connection with its unrelated trade or business activities.

(7) *Intangible drilling and development costs.* See section 263A(c)(3) for an exception for intangible drilling and development costs. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under sections 263(c), 616(a), or 617(a).

(8) *Natural gas acquired for resale.* Under this paragraph (b)(8), section 263A does not apply to any costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs would otherwise be allocable to cushion gas.

(i) *Cushion gas.* Cushion gas is the portion of gas stored in an underground storage facility or reservoir that is required to maintain the level of pressure necessary for operation of the facility. However, section 263A applies to costs incurred by a taxpayer relating to natural gas acquired for resale to the extent such costs are properly allocable to emergency gas.

(ii) *Emergency gas.* Emergency gas is natural gas stored in an underground storage facility or reservoir for use during periods of unusually heavy customer demand.

(9) *Research and experimental expenditures.* See section 263A(c)(2) for an exception for any research and experimental expenditure allowable as a deduction under section 174 or the regulations thereunder. Additionally, section 263A does not apply to any amount allowable as a deduction under section 59(e) with respect to qualified expenditures under section 174.

(10) *Certain property that is substantially constructed.* Section 263A does not apply to any property produced by a taxpayer for use in its trade or business if substantial construction occurred before March 1, 1986.

(i) For purposes of this section, substantial construction is deemed to have occurred if the lesser of—

(A) 10 percent of the total estimated costs of construction; or

(B) The greater of $10 million or 2 percent of the total estimated costs of construction, was incurred before March 1, 1986.

(ii) For purposes of the provision in paragraph (b)(10)(i) of this section, the total estimated costs of construction shall be determined by reference to a reasonable estimate, on or before March 1, 1986, of such amount. Assume, for example, that on March 1, 1986, the estimated costs of constructing a facility were $150 million. Assume that before March 1, 1986, $12 million of construction costs had been incurred. Based on the above facts, substantial construction would be deemed to have occurred before March 1, 1986, because $12 million (the costs of construction incurred before such date) is greater than $10 million (the lesser of $15 million; or the greater of $10 million or $3 million). For purposes of this provision, construction costs are defined as those costs incurred after construction has commenced at the site of the property being constructed (unless the property will not be located on land and, therefore, the initial construction of the property must begin at a location other than the intended site). For example, in the case of a building, construction commences when work begins on the building, such as the excavation of the site, the pouring of pads for the building, or the driving of foundation pilings into the ground. Preliminary activities such as project engineering and architectural design do not constitute the commencement of construction, nor are such costs considered construction costs, for purposes of this paragraph (b)(10).

(11) *Certain property provided incident to services*—(i) *In general.* Under this paragraph (b)(11), section 263A does not apply to property that is provided to a client (or customer) incident to the provision of services by the taxpayer if the property provided to the client is—

(A) De minimis in amount; and

(B) Not inventory in the hands of the service provider.

(ii) *Definition of services.* For purposes of this paragraph (b)(11), services is defined with reference to its ordinary and accepted meaning under federal income tax principles. In determining whether a taxpayer is a bona-fide service provider under this paragraph (b)(11), the nature of the taxpayer's trade or business and the facts and circumstances surrounding the taxpayer's trade or business activities must be considered. Examples of taxpayers qualifying as service providers under this paragraph include taxpayers performing services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

(iii) *De minimis property provided incident to services.* In determining whether property provided to a client by a service provider is de minimis in amount, all facts and circumstances, such as the nature of the taxpayer's trade or business and the volume of its service activities in the trade or business, must be considered. A significant factor in making this determination is the relationship between the acquisition or direct materials costs of the property that is provided to clients and the price that the taxpayer charges its clients for its services and the property. For purposes of this paragraph (b)(11), if the acquisition or direct materials cost of the property provided to a client incident to the services is less than or equal to five percent of the price charged to the client for the services and property, the property is de minimis. If the acquisition or direct materials cost of the property exceeds five percent of the price charged for the services and property, the property may be de minimis if additional facts and circumstances so indicate.

(12) *De minimis rule for certain producers with total indirect costs of $200,000 or less.* See § 1.263A–2(b)(3)(iv) for a de minimis rule that treats producers with total indirect costs of $200,000 or less as having no additional section 263A costs (as defined in paragraph (d)(3) of this section) for purposes of the simplified production method.

(13) *Exception for the origination of loans.* For purposes of section 263A(b)(2)(A), the origination of loans is not considered the acquisition of intangible property for resale. (But section 263A(b)(2)(A) does include the acquisition by a taxpayer of pre-existing loans from other persons for resale.)

(c) *General operation of section 263A*—(1) *Allocations.* Under section 263A, taxpayers must capitalize their direct costs and a properly allocable share of their indirect costs to property produced or property acquired for resale. In order to determine these capitalizable costs, taxpayers must allocate or apportion costs to various activities, including production or resale activities. After section 263A costs are allocated to the appropriate production or resale activities, these costs are generally allocated to the items of property produced or property acquired for resale during the taxable year and capitalized to the items that remain on hand at the end of the taxable year. See however, the simplified production method, the modified simplified production method, and the simplified resale method in §§ 1.263A–2(b) and (c) and 1.263A–3(d).

(2) *Otherwise deductible.* (i) Any cost which (but for section 263A and the regulations thereunder) may not be taken into account in computing taxable income for any taxable year is not treated as a cost properly allocable to property produced or acquired for resale under section 263A and the regulations thereunder. Thus, for example, if a business meal deduction is limited by section 274(n) to 80 percent of the cost of the meal, the amount properly allocable to property produced or acquired for resale under section 263A is also limited to 80 percent of the cost of the meal.

(ii) The amount of any cost required to be capitalized under section 263A may not be included in inventory or charged to capital accounts or basis any earlier than the taxable year during which the amount is incurred within the meaning of § 1.446–1(c)(1)(ii).

(3) *Capitalize.* Capitalize means, in the case of property that is inventory in the hands of a taxpayer, to include in inventory costs and, in the case of other property, to charge to a capital account or basis.

(4) *Recovery of capitalized costs.* Costs that are capitalized under section 263A are recovered through depreciation, amortization, cost of goods sold, or by an adjustment to basis at the time the property is used, sold, placed in service, or otherwise disposed of by the taxpayer. Cost recovery is determined by the applicable Internal Revenue Code and regulation provisions relating to use, sale, or disposition of property.

(5) *Costs allocable to property sold.* A cost that is allocated under this section, § 1.263A–2, or § 1.263A–3 entirely to property sold must be included in cost of goods sold and may not be included in determining the cost of goods on hand at the end of the taxable year.

(d) *Definitions*—(1) *Self-constructed assets.* Self-constructed assets are assets produced by a taxpayer for use by the taxpayer in its trade or business. Self-constructed assets are subject to section 263A.

(2) *Section 471 costs*—(i) *In general.* Except as otherwise provided in paragraphs (d)(2)(ii), (iv), (v), and (vi) of this section, for purposes of section 263A, a taxpayer's section 471 costs are the types of costs, other than interest, that a taxpayer capitalizes to property produced or property acquired for resale in its financial statement. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, that a taxpayer capitalizes to, or includes in acquisition or production costs of, property produced or property acquired for resale in its financial statement. Except as otherwise provided in paragraph (d)(2)(iii) of this section, a taxpayer determines the amounts of section 471 costs by using

the amounts of such costs that are incurred in the taxable year for federal income tax purposes.

(ii) *Inclusion of direct costs*—(A) *In general*. Notwithstanding the last sentence of paragraph (g)(2) of this section, a taxpayer's section 471 costs must include all direct costs of property produced and property acquired for resale, whether or not a taxpayer capitalizes these costs to property produced or property acquired for resale in its financial statement. See paragraph (e)(2) of this section for a description of direct costs of property produced and property acquired for resale.

(B) *Allocation of direct costs*. Except for any direct costs that are treated as additional section 263A costs under paragraphs (d)(2)(iv) and (v) of this section, a taxpayer's direct costs of property produced and property acquired for resale must be allocated using a method provided in paragraph (f) of this section.

(iii) *Alternative method to determine amounts of section 471 costs by using taxpayer's financial statement*—(A) *In general*. In lieu of determining the amounts of section 471 costs under paragraph (d)(2)(i) of this section, a taxpayer described in paragraph (d)(3)(ii)(B) of this section may determine the amounts of section 471 costs by using the amounts of such costs that are incurred in the taxable year in its financial statement using the taxpayer's financial statement methods of accounting if the taxpayer's financial statement is described in paragraph (d)(6)(i), (ii), or (iii) of this section. If the taxpayer's financial statement is described only in paragraph (d)(6)(iv) of this section, the taxpayer may not use the alternative method described in this paragraph (d)(2)(iii) and must use the method described in paragraph (d)(2)(i) of this section to determine its amounts of section 471 costs. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) must remove all section 471 costs described in paragraph (d)(2)(vi) of this section, if any, by including negative adjustments in additional section 263A costs. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) applies the method to all of its section 471 costs, including costs described under paragraphs (d)(2)(ii), (iv), (v), and (vi) of this section.

(B) *Book-to-tax adjustments*. A taxpayer using the alternative method described in this paragraph (d)(2)(iii) must include as additional section 263A costs all negative and positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer's section 471 costs, including adjustments for direct costs required to be added to section 471 costs under paragraph (d)(2)(ii) of this section, and costs removed from section 471 costs under paragraphs (d)(2)(vi) and (d)(3)(ii)(B) of this section. In addition, the taxpayer must include as additional section 263A costs all negative and positive adjustments required to be made as a result of differences in the book and tax amounts of section 471 costs that are treated as additional section 263A costs (for example, de minimis direct costs described in paragraph (d)(2)(iv) of this section and certain variances and under or over-applied burdens described in paragraph (d)(2)(v) of this section). For purposes of determining the negative and positive adjustments required to be made as a result of differences in book and tax amounts for a taxpayer using the burden rate or standard cost methods described in paragraph (f)(3) of this section, the taxpayer compares the actual amount of the cost incurred in the taxable year for federal income tax purposes to the actual amount of the cost incurred in the taxable year in its financial statement using the taxpayer's financial statement methods of accounting, regardless of how the taxpayer treats its variances or under or over-applied burdens.

(C) *Exclusion of certain financial statement items*. A taxpayer that determines the amounts of section 471 costs under this paragraph (d)(2)(iii) may not include any financial statement write-downs, reserves, or other financial statement valuation adjustments when determining the amounts of its section 471 costs.

(D) *Changes in method of accounting*. The use of this method to determine the amounts of section 471 costs under this paragraph (d)(2)(iii) is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(E) *Examples*. The following examples illustrate this paragraph (d)(2)(iii):

(*1*) *Example 1—Alternative-method taxpayer using de minimis direct labor costs rule*. Taxpayer P uses the modified simplified production method described in §1.263A–2(c) and determines its amounts of section 471 costs by using the alternative method under paragraph (d)(2)(iii) of this section. Additionally, P uses the de minimis direct labor costs rule under paragraph (d)(2)(iv)(B) of this section. P does not capitalize vacation pay or holiday pay to property produced or property acquired for resale in its financial statement but does capitalize all other direct labor costs to such property in its financial statement. On its 2018 financial statement, P incurs $3,500,000 of total direct labor costs, including $110,000 of vacation pay costs and $10,000 of holiday pay costs. For federal income tax purposes, P incurs $150,000 of vacation pay costs and $18,000 of holiday pay costs in the taxable year. P's uncapitalized direct labor costs are $120,000 ($110,000 of vacation pay plus $10,000 of holiday pay). For purposes of the five percent test in paragraph (d)(2)(iv)(B) of this section, P's uncapitalized direct labor costs are 3.43% of total direct labor costs ($120,000 divided by $3,500,000). Accordingly, under paragraph (d)(2)(iv)(B) of this section, P includes $120,000 in its additional section 263A costs and excludes that amount from its section 471 costs in the taxable year. Additionally, pursuant to paragraph (d)(2)(iii)(B) of this section, P includes in additional section 263A costs a positive book-to-tax adjustment of $40,000 for vacation pay costs ($150,000 tax amount − $110,000 book amount) and a positive book-to-tax adjustment of $8,000 for holiday pay costs ($18,000 tax amount − $10,000 book amount).

(*2*) *Example 2—Alternative-method taxpayer with under and over-applied burdens that uses safe harbor rule for certain variances and under or over-applied burdens*. Taxpayer X uses the modified simplified production method described in §1.263A–2(c) and determines its amounts of section 471 costs by using the alternative method under paragraph (d)(2)(iii) of this section. In 2018, X uses a burden rate method for book purposes to allocate costs to Products A and B, and does not capitalize any under or over-applied burdens to property produced or property acquired for resale in its financial statement. X does not allocate costs to any other products using a burden rate method, and X does not allocate costs to any products using a standard cost method. On its 2018 financial statement, using X's burden rate, the total amount of predetermined indirect costs for Product A is $545,000 and the total amount of actual indirect costs incurred for Product A is $550,000; accordingly, X has an under-applied burden of $5,000 for Product A. For federal income tax purposes, the actual indirect costs incurred in 2018 for Product A is $560,000. Additionally, on its 2018 financial statement, using X's burden rate, the total amount of predetermined indirect costs for Product B is $250,000 and the total amount of actual indirect costs incurred for Product B is $225,000; accordingly, X has an over-applied burden of $25,000 for Product B. For federal income tax purposes, the actual indirect costs incurred in 2018 for Product B is $240,000. X uses the safe harbor rule for certain variances and under or over-applied burdens. Prior to the application of this safe harbor rule, X's total section 471 costs for 2018 for Products A and B (the only items to which X allocates costs using a standard cost method or burden rate method) are $2,000,000, which includes $550,000 actual indirect costs for Product A, $225,000 actual indirect costs for Product B, and $1,225,000 of other section 471 costs for Products A and B that are not allocated under X's burden rate method. For purposes of determining the amount of uncapitalized variances and uncapitalized under or over-applied burdens for the five percent test in paragraph (d)(2)(v)(A) of this section, X's under and over-applied burdens for Products A and B are treated as positive amounts. Consequently, the sum of X's uncapitalized variances and uncapitalized under or over-applied burdens is $30,000 ($5,000 under-applied burden for Product A plus $25,000 over-applied burden for Product B). Accordingly, under paragraph (d)(2)(v)(A) of this section, the sum of X's uncapitalized variances and uncapitalized under or over-applied burdens is 1.5% of X's total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method ($30,000 divided by $2,000,000), and X includes a positive $5,000 under-applied burden for Product A and a negative $25,000 over-applied burden for Product B in its additional section 263A costs, and excludes those amounts from its section 471 costs. Additionally, pursuant to paragraph (d)(2)(iii)(B) of this section, X includes in its additional section 263A costs a positive book-to-tax adjustment of $10,000 for Product A ($560,000 actual cost tax amount − $550,000 actual cost book amount) and a positive book-to-tax adjustment of $15,000 for Product B ($240,000 actual tax amount cost − $225,000 actual book amount cost) in the taxable year.

(iv) *De minimis rule exceptions for certain direct costs*—(A) *In general*. Notwithstanding paragraph (d)(2)(ii) of this section, a taxpayer that uses the simplified resale method, the simplified production method, or the modified simplified production method, and that does not capitalize certain direct costs to property produced or property acquired for resale in its financial statement (uncapitalized direct labor costs or uncapitalized direct material costs), may use either or both the de minimis direct labor costs rule or the de minimis direct material costs rule to include in additional section 263A costs, and exclude from section 471 costs, certain uncapitalized direct labor costs or uncapitalized direct material costs that are incurred in the taxable year as provided in paragraphs (d)(2)(iv)(B) and (C) of this section, respectively. The use of the de minimis rules described in paragraphs (d)(2)(iv)(B) and (C) of this section is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(B) *De minimis rule for certain direct labor costs*. A taxpayer described in paragraph (d)(2)(iv)(A) of this section that uses the de minimis rule described in this paragraph (d)(2)(iv)(B) includes in additional section 263A costs, and excludes from section 471 costs, the sum of the amounts of all of those uncapitalized direct labor costs that are incurred in the taxable year, if that sum is less than five percent of total direct labor costs incurred in the taxable year (whether or not capitalized in the taxpayer's financial statement), or another amount specified in other published guidance (*see* § 601.601(d)(2) of this chapter). For purposes of determining the amount of uncapitalized direct labor costs for this five percent test, any amounts that constitute a reduction to costs are treated as a positive amount. The amounts of uncapitalized direct labor costs used for the five percent test, and the amounts of uncapitalized direct labor costs included in additional section 263A costs under this paragraph (d)(2)(iv)(B), must not include amounts relating to basic compensation or overtime, or the types of costs included in the taxpayer's standard cost or burden rate methods used for section 471 costs (but see paragraphs (d)(2)(v) and (f)(3)(i)(C) of this section for special rules for certain variances and under or over-applied burdens).

(C) *De minimis rule for certain direct material costs*. A taxpayer described in paragraph (d)(2)(iv)(A) of this section that uses the de minimis rule described in this paragraph (d)(2)(iv)(C) includes in additional section 263A costs, and excludes from section 471 costs, the sum of the amounts of all of those uncapitalized direct material costs that are incurred in the taxable year, if that sum is less than five percent of total direct material costs incurred in the taxable year (whether or not capitalized in the taxpayer's financial statement), or another amount specified in other published guidance (*see* § 601.601(d)(2) of this chapter). For purposes of determining the amount of uncapitalized direct material costs for this five percent test, any amounts that constitute a reduction to costs, such as cash and trade discounts, are treated as a positive amount. The amounts of uncapitalized direct material costs used for the five percent test, and the amounts of uncapitalized direct material costs included in additional section 263A costs under this paragraph (d)(2)(iv)(C), must not include the types of costs included in the taxpayer's standard cost method used for section 471 costs (but see paragraphs (d)(2)(v) and (f)(3)(ii)(B) of this section for special rules for certain variances).

(D) *Taxpayers using a historic absorption ratio*. A taxpayer that uses the historic absorption ratio provided in §1.263A–2(b)(4) or (c)(4) or §1.263A–3(d)(4), and that uses a de minimis rule described in paragraph (d)(2)(iv) of this section during its test period or updated test period, determines whether direct labor costs or direct material costs, as applicable, are included in any of its section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period according to how those direct labor costs or direct material costs, respectively, are identified in at least two of the three years of the taxpayer's applicable test period or updated test period. If a taxpayer described in this paragraph (d)(2)(iv)(D) is required to revise any of its actual absorption ratios for its test period or updated test period as a result of a change in a method of accounting, the taxpayer determines whether direct labor costs or direct material costs, as applicable, are included in any of its section 471 costs on hand at year end during a qualifying period or extended qualifying period according to how those direct labor costs or direct material costs, respectively, are identified in the taxpayer's revised actual absorption ratios during its applicable test period or updated test period.

(E) *Examples*. The following examples illustrate this paragraph (d)(2)(iv):

(*1*) *Example 1—Taxpayer using de minimis direct material costs rule*. Taxpayer R uses the modified simplified production method described in §1.263A–2(c) and the de minimis method of accounting under paragraph (d)(2)(iv)(C) of this section. In 2018, R does not capitalize freight-in costs or trade discounts to property produced or property acquired for resale in its financial statement but does capitalize all other direct material costs to such property in its financial statement. R incurs total direct material costs of $3,105,000, which represents invoice price of $3,000,000 on goods purchased, plus $120,000 of freight-in costs, less $15,000 for trade discounts. For purposes of determining the amount of uncapitalized direct material costs for the five percent test in paragraph (d)(2)(iv)(C) of this section, R's trade discounts are treated as a positive amount. Consequently, R's uncapitalized direct material costs for purposes of the five percent test are $135,000 ($120,000 of freight-in plus $15,000 of trade discounts). Accordingly, under paragraph (d)(2)(iv)(C) of this section, R's uncapitalized direct material costs are 4.35% of total direct material costs ($135,000 divided by $3,105,000), and R includes a positive $120,000 of freight-in and a negative $15,000 of trade discounts in its additional section 263A costs and excludes those amounts from its section 471 costs in the taxable year.

(*2*) *Example 2—Taxpayer using de minimis direct labor costs rule and historic absorption ratio*. Taxpayer S uses the historic absorption ratio provided in §1.263A–2(c)(4). S uses the de minimis method of accounting under paragraph (d)(2)(iv)(B). S excludes certain uncapitalized direct labor costs from its section 471 costs (and includes them in additional section 263A costs) under paragraph (d)(2)(iv)(B) of this section in Years 1 and 3 of its applicable test period. Because S excluded direct labor costs from its section 471 costs in at least two of the three years of its applicable test period, S must exclude those same costs from its pre-production and production section 471 costs remaining on hand at year end during its qualifying period or extended qualifying period.

(v) *Safe harbor method for certain variances and under or over-applied burdens*—(A) *In general*. Notwithstanding paragraphs (d)(2)(i) and (ii), (f)(3)(i)(C), and (f)(3)(ii)(B) of this section, a taxpayer that uses the simplified resale method, the simplified production method, or the modified simplified production method, may use the safe harbor method described in this paragraph (d)(2)(v)(A) for all of its variances and under or over-applied burdens that are not capitalized to property produced or property acquired for resale in its financial statement (uncapitalized variances and uncapitalized under or over-applied burdens). A taxpayer using this safe harbor method must include in additional section 263A costs, and exclude from section 471 costs, the sum of the amounts of all of those uncapitalized variances and uncapitalized under or over-applied burdens for the taxable year, if that sum is less than five percent of the taxpayer's total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method, or another percentage specified in other published guidance (*see* § 601.601(d)(2) of this chapter). If the sum of uncapitalized variances and uncapitalized under or over-applied burdens is not less than this five percent threshold, the taxpayer may not exclude such uncapitalized variances and uncapitalized under or over-applied burdens from section 471 costs, and must reallocate such uncapitalized variances and uncapitalized under or over-applied burdens to or among the units of property to which the costs are allocable in accordance with paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section (but see paragraph (d)(2)(v)(B) of this section for a rule that a taxpayer using the safe harbor method described in this paragraph (d)(2)(v)(A) may not use the methods of accounting described in paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section to treat certain uncapitalized variances and certain uncapitalized under or over-applied burdens as not allocable to property). For purposes of determining the amounts of uncapitalized variances and uncapitalized under or over-applied burdens for this five percent test, all variances and under or over-applied burdens are treated as positive amounts. Additionally, for purposes of this five percent test, a taxpayer's total section 471 costs for all items to which it allocates costs using a standard cost method or burden rate method are determined before application of the safe harbor method described in this paragraph (d)(2)(v)(A), and therefore this amount must reflect the actual amounts incurred by the taxpayer for those items during the taxable year, which includes variances and under or over-applied burdens. The variances described in this paragraph (d)(2)(v)(A) include any variances on cash or trade discounts, if those discounts are capitalized as part of the taxpayer's standard cost method used for section 471 costs.

(B) *Consistency requirement.* A taxpayer using the safe harbor method described in paragraph (d)(2)(v)(A) of this section must use the method consistently for all items to which it allocates costs using a standard cost method or burden rate method and may not use the methods of accounting described in paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section to treat its uncapitalized variances and uncapitalized under or over-applied burdens that are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year as not allocable to property produced or property acquired for resale.

(C) *Allocation of variances and under or over-applied burdens between production and preproduction costs under the modified simplified production method.* In the case of a taxpayer using the modified simplified production method and the safe harbor method described in paragraph (d)(2)(v)(A) of this section, uncapitalized variances and uncapitalized under or over-applied burdens treated as additional section 263A costs under the safe harbor method must be allocated between production additional section 263A costs, as described in § 1.263A–2(c)(3)(ii)(D)(*1*), and pre-production additional section 263A costs, as described in § 1.263A–2(c)(3)(ii)(B)(*1*), using any reasonable method. In the case of a taxpayer using the modified simplified production method and the safe harbor method described in paragraph (d)(2)(v)(A) of this section, uncapitalized variances and uncapitalized under or over-applied burdens that are not excluded from section 471 costs must be allocated between production section 471 costs, as described in § 1.263A–2(c)(3)(ii)(D)(*3*), and pre-production section 471 costs, as described in § 1.263A–2(c)(3)(ii)(B)(*2*) based on the taxpayer's reallocation of such uncapitalized variances and uncapitalized under or over-applied burdens to or among the units of property to which the costs are allocable in accordance with paragraphs (f)(3)(i)(C) and (f)(3)(ii)(B) of this section, as described in paragraph (d)(2)(v)(A) of this section.

(D) *Allocation of variances and under or over-applied burdens between storage and handling costs absorption ratio and purchasing costs absorption ratio under the simplified resale method.* In the case of a taxpayer using the simplified resale method, any uncapitalized variances and uncapitalized under or over-applied burdens treated as additional section 263A costs under the safe harbor method described in paragraph (d)(2)(v)(A) of this section must be allocated between storage and handling costs, as described in §1.263A–3(d)(3)(i)(D)(*2*), and current year's purchasing costs, as described in §1.263A–3(d)(3)(i)(E)(*2*), using any reasonable method.

(E) *Method of accounting.* The use of the safe harbor method described in this paragraph (d)(2)(v) is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(vi) *Removal of section 471 costs.* A taxpayer must remove those costs included in its section 471 costs that are not permitted to be capitalized under either paragraph (c)(2) or (j)(2)(ii) of this section and those costs included in its section 471 costs that are eligible for capitalization under paragraph (j)(2) of this section that the taxpayer does not elect to capitalize under section 263A. Except as otherwise provided in paragraph (d)(3)(ii)(B) of this section, a taxpayer must remove costs pursuant to this paragraph (d)(2)(vi) by adjusting its section 471 costs and may not remove the costs by including a negative adjustment in its additional section 263A costs. A taxpayer that removes costs pursuant to this paragraph (d)(2)(vi) by adjusting its section 471 costs must use a reasonable method that approximates the manner in which the taxpayer originally capitalized the costs to its property produced or property acquired for resale in its financial statement.

(vii) *Method changes.* A taxpayer using the simplified production method, simplified resale method, or the modified simplified production method and that changes its financial statement practices for a cost in a manner that would change its section 471 costs is required to change its method of accounting for federal income tax purposes. A taxpayer may change its method of accounting for determining section 471 costs only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations.

(3) *Additional section 263A costs*—(i) *In general.* Additional section 263A costs are the costs, other than interest, that are not included in a taxpayer's section 471 costs but that are required to be capitalized under section 263A. Additional section 263A costs generally do not include the direct costs that are required to be included in a taxpayer's section 471 costs under paragraph (d)(2)(ii) of this section; however, additional section 263A costs must include any direct costs excluded from section 471 costs under paragraphs (d)(2)(iv) and (v) of this section. For a taxpayer using the alternative method described in paragraph (d)(2)(iii) of this section, additional section 263A costs must also include any negative or positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer's section 471 costs.

(ii) *Negative adjustments*—(A) *In general.* Except as otherwise provided by regulations or other published guidance (*see* §601.601(d)(2) of this chapter), a taxpayer may not include negative adjustments in additional section 263A costs. However, for a taxpayer using the alternative method described in paragraph (d)(2)(iii) of this section, see paragraph (d)(2)(iii)(B) of this section for negative or positive adjustments required to be made as a result of differences in the book and tax amounts of the taxpayer's section 471 costs.

(B) *Exception for certain taxpayers removing costs from section 471 costs.* Notwithstanding paragraphs (d)(2)(vi) and (d)(3)(ii)(A) of this section, and except as otherwise provided in paragraphs (d)(3)(ii)(C) and (D) of this section, the following taxpayers may, but are not required to, include negative adjustments in additional section 263A costs to remove the taxpayer's section 471 costs that are described in paragraph (d)(2)(vi) of this section (costs that are not required to be, or are not permitted to be, capitalized under section 263A):

(*1*) A taxpayer using the simplified production method under § 1.263A–2(b) if the taxpayer's (or its predecessor's) average annual gross receipts for the three previous taxable years (test period) do not exceed $50,000,000, or another amount specified in other published guidance (*see* § 601.601(d)(2) of this chapter). The rules of § 1.263A–1(j) apply for purposes of determining the amount of a taxpayer's gross receipts and the test period;

(*2*) A taxpayer using the modified simplified production method under § 1.263A–2(c); and

(*3*) A taxpayer using the simplified resale method under § 1.263A–3(d).

(C) *No negative adjustments for cash or trade discounts.* A taxpayer may not include negative adjustments in additional section 263A costs for cash or trade discounts described in § 1.471–3(b). However, see paragraph (d)(2)(iv)(C) of this section for a de minimis rule for certain direct material costs that may be included in additional section 263A costs and paragraph (d)(2)(v) of this section for certain variance amounts that may be included in additional section 263A costs.

(D) *No negative adjustments for certain expenses.* A taxpayer may not include negative adjustments in additional section 263A costs for an amount which is of a type for which a deduction would be disallowed under section 162(c), (e), (f), or (g) and the regulations thereunder in the case of a business expense.

(E) *Consistency requirement for negative adjustments.* A taxpayer that is permitted to include negative adjustments in additional section 263A costs to remove section 471 costs under paragraph (d)(3)(ii)(B) of this section and that includes negative adjustments to remove section 471 costs must use that method of accounting to remove all section 471 costs required to be removed under paragraph (d)(2)(vi) of this section.

(4) *Section 263A costs.* Section 263A costs are defined as the costs that a taxpayer must capitalize under section 263A. Thus, section 263A costs are the sum of a taxpayer's section 471 costs, its additional section 263A costs, and interest capitalizable under section 263A(f).

(5) *Classification of costs.* A taxpayer must classify section 471 costs, additional section 263A costs, and any permitted adjustments to section 471 or additional section 263A costs, using the narrower of the classifications of costs described in paragraphs (e)(2), (3), and (4) of this section, whether or not the taxpayer is required to maintain inventories, or the classifications of costs used by a taxpayer in its financial statement. If a cost is not described in paragraph (e)(2), (3), or (4) of this section, the cost is to be classified using the classification of costs used in the taxpayer's financial statement.

(6) *Financial statement.* For purposes of section 263A, financial statement means the taxpayer's financial statement listed in paragraphs (d)(6)(i) through (iv) of this section that has the highest priority, including within paragraphs (d)(6)(ii) and (iv) of this section. The financial statements are, in descending priority:

(i) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10–K or the Annual Statement to Shareholders);

(ii) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for:

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose;

(iii) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service); or

(iv) A financial statement that is used for:

(A) Credit purposes;

(B) Reporting to shareholders, partners, or similar persons; or

(C) Any other substantial non-tax purpose.

(e) *Types of costs subject to capitalization*—(1) *In general.* Taxpayers subject to section 263A must capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale. This paragraph (e) describes the types of costs subject to section 263A.

(2) *Direct costs*—(i) *Producers.* Producers must capitalize direct material costs and direct labor costs.

(A) *Direct material costs. Direct materials costs* include the cost of those materials that become an integral part of specific property produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. For example, a cost described in §1.162–3, relating to the cost of a material or supply, may be a direct material cost.

(B) *Direct labor costs* include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. For this purpose, labor encompasses full-time and part-time employees, as well as contract employees and independent contractors. Direct labor costs include all elements of compensation other than employee benefit costs described in paragraph (e)(3)(ii)(D) of this section. Elements of direct labor costs include basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983), shift differential, payroll taxes, and payments to a supplemental unemployment benefit plan.

(ii) *Resellers.* Resellers must capitalize the acquisition costs of property acquired for resale. In the case of inventory, the acquisition cost is the cost described in §1.471–3(b).

(3) *Indirect costs*—(i) *In general.* (A) Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may directly benefit or be incurred by reason of the performance of production or resale activities even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers must make a reasonable allocation of indirect costs between production, resale, and other activities.

(B) *Example.* The following example illustrates the provisions of this paragraph (e)(3)(i):

(i) Taxpayer A manufactures tablecloths and other linens. A enters into a licensing agreement with Company L under which A may label its tablecloths with L's trademark if the tablecloths meet certain specified quality standards. In exchange for its right to use L's trademark, the licensing agreement requires A to pay L a royalty of $X for each tablecloth carrying L's trademark that A sells. The licensing agreement does not require A to pay L any minimum or lump-sum royalties.

(ii) The licensing agreement provides A with the right to use L's intellectual property, a trademark. The licensing agreement also requires A to conduct its production activities according to certain standards as a condition of exercising that right. Thus, A's right to use L's trademark under the licensing agreement is directly related to A's production of tablecloths. The royalties the licensing agreement requires A to pay for using L's trademark are the costs A incurs in exchange for these rights. Therefore, although A incurs royalty costs only when A sells a tablecloth carrying L's trademark, the royalty costs directly benefit production activities and are incurred by reason of production activities within the meaning of paragraph (e)(3)(i)(A) of this section.

(ii) *Examples of indirect costs required to be capitalized.* The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

(A) *Indirect labor costs.* Indirect labor costs include all labor costs (including the elements of labor costs set forth in paragraph (e)(2)(i) of this section) that cannot be directly identified or associated with particular units or groups of units of specific property produced or property acquired for resale (e.g., factory labor that is not direct labor). As in the case of direct labor, indirect labor encompasses full-time and part-time employees, as well as contract employees and independent contractors.

(B) *Officers' compensation.* Officers' compensation includes compensation paid to officers of the taxpayer.

(C) *Pension and other related costs.* Pension and other related costs include contributions paid to or made under any stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation, whether or not the plan qualifies under section 401(a). Contributions to employee plans representing past services must be capitalized in the same manner (and in the same proportion to property currently being acquired or produced) as amounts contributed for current service.

(D) *Employee benefit expenses.* Employee benefit expenses include all other employee benefit expenses (not described in paragraph (e)(3)(ii)(C) of this section) to the extent such expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code. These other employee benefit expenses include: worker's compensation; amounts otherwise deductible or allowable in reducing earnings and profits under section 404A; payments pursuant to a wage continuation plan under section 105(d) as it existed prior to its repeal in 1983; amounts includible in the gross income of employees under a method or arrangement of employer contributions or compensation that has the effect of a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring receipt of compensation or providing deferred benefits; premiums on life and health insurance; and miscellaneous benefits provided for employees such as safety, medical treatment, recreational and eating facilities, membership dues, etc. Employee benefit expenses do not, however, include direct labor costs described in paragraph (e)(2)(i) of this section.

(E) *Indirect material costs. Indirect material costs* include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property. Thus, for example, a cost described in §1.162–3, relating to the cost of a material or supply, may be an indirect cost.

(F) *Purchasing costs.* Purchasing costs include costs attributable to purchasing activities. See §1.263A–3(c)(3) for a further discussion of purchasing costs.

(G) *Handling costs.* Handling costs include costs attributable to processing, assembling, repackaging and transporting goods, and other similar activities. See §1.263A–3(c)(4) for a further discussion of handling costs.

(H) *Storage costs.* Storage costs include the costs of carrying, storing, or warehousing property. See §1.263A–3(c)(5) for a further discussion of storage costs.

(I) *Cost recovery.* Cost recovery includes depreciation, amortization, and cost recovery allowances on equipment and facilities (including depreciation or amortization of self-constructed assets or other previously produced or acquired property to which section 263A or section 263 applies).

(J) *Depletion.* Depletion includes allowances for depletion, whether or not in excess of cost. Depletion is, however, only properly allocable to property that has been sold (i.e., for purposes of determining gain or loss on the sale of the property).

(K) *Rent.* Rent includes the cost of renting or leasing equipment, facilities, or land.

(L) *Taxes.* Taxes include those taxes (other than taxes described in paragraph (e)(3)(iii)(F) of this section) that are otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities.

(M) *Insurance.* Insurance includes the cost of insurance on plant or facility, machinery, equipment, materials, property produced, or property acquired for resale.

(N) *Utilities.* Utilities include the cost of electricity, gas, and water.

(O) *Repairs and maintenance.* Repairs and maintenance include the cost of repairing and maintaining equipment or facilities.

(P) *Engineering and design costs.* Engineering and design costs include preproduction costs, such as costs attributable to research, experimental, engineering, and design activities (to the extent that such amounts are not research and experimental expenditures as described in section 174 and the regulations thereunder).

(Q) *Spoilage.* Spoilage includes the costs of rework labor, scrap, and spoilage.

(R) *Tools and equipment.* Tools and equipment include the costs of tools and equipment which are not otherwise capitalized.

(S) *Quality control.* Quality control includes the costs of quality control and inspection.

(T) *Bidding costs.* Bidding costs are costs incurred in the solicitation of contracts (including contracts pertaining to property acquired for resale) ultimately awarded to the taxpayer. The taxpayer must defer all bidding costs paid or incurred in the solicitation of a particular contract until the contract is awarded. If the contract is awarded to the taxpayer, the bidding costs become part of the indirect costs allocated to the subject matter of the contract. If the contract is not awarded to the taxpayer, bidding costs are deductible in the taxable year that the contract is awarded to another party, or in the taxable year that the taxpayer is notified in writing that no contract will be awarded and that the contract (or a similar or related contract) will not be rebid, or in the taxable year that the taxpayer abandons its bid or proposal, whichever occurs first. Abandoning a bid does not include modifying, supplementing, or changing the original bid or proposal. If the taxpayer is awarded only part of the bid (for example, the taxpayer submitted one bid to build each of two different types of products, and the taxpayer was awarded a contract to build only one of the two types of products), the taxpayer shall deduct the portion of the bidding costs related to the portion of the bid not awarded to the taxpayer. In the case of a bid or proposal for a multi-unit contract, all bidding costs must be included in the costs allocated to the subject matter of the contract awarded to the taxpayer to produce or acquire for resale any of such units. For example, where the taxpayer submits one bid to produce three similar turbines and the taxpayer is awarded a contract to produce only two of the three turbines, all bidding costs must be included in the cost of the two turbines. For purposes of this paragraph (e)(3)(ii)(T), a contract means—

(*1*) In the case of a specific unit of property, any agreement under which the taxpayer would produce or sell property to another party if the agreement is entered into before the taxpayer produces or acquires the specific unit of property to be delivered to the party under the agreement; and

(*2*) In the case of fungible property, any agreement to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy the agreement (plus any other production or sales agreements of the taxpayer).

(U) *Licensing and franchise costs.* (*1*) Licensing and franchise costs include fees incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. These costs include the otherwise deductible portion (such as amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and any royalties that are incurred by a licensee or a franchisee. These costs also include fees, payments, and royalties otherwise described in this paragraph (e)(3)(ii)(U) that a taxpayer incurs (within the meaning of section 461) only upon the sale of property produced or acquired for resale.

(*2*) If a taxpayer incurs (within the meaning of section 461) a fee, payment, or royalty described in this paragraph (e)(3)(ii)(U) only upon the sale of property produced or acquired for resale and the cost is required to be capitalized under this paragraph (e)(3), the taxpayer may properly allocate the cost entirely to property produced or acquired for resale by the taxpayer that has been sold.

(V) *Interest.* Interest includes interest on debt incurred or continued during the production period to finance the production of real property or tangible personal property to which section 263A(f) applies.

(W) *Capitalizable service costs.* Service costs that are required to be capitalized include capitalizable service costs and capitalizable mixed service costs as defined in paragraph (e)(4) of this section.

(iii) *Indirect costs not capitalized.* The following indirect costs are not required to be capitalized under section 263A:

(A) *Selling and distribution costs.* These costs are marketing, selling, advertising, and distribution costs.

(B) *Research and experimental expenditures.* Research and experimental expenditures are expenditures described in section 174 and the regulations thereunder.

(C) *Section 179 costs.* Section 179 costs are expenses for certain depreciable assets deductible at the election of the taxpayer under section 179 and the regulations thereunder.

(D) *Section 165 losses.* Section 165 losses are losses under section 165 and the regulations thereunder.

(E) *Cost recovery allowances on temporarily idle equipment and facilities*—(*1*) *In general.* Cost recovery allowances on temporarily idle equipment and facilities include only depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle. Equipment and facilities are temporarily idle when a taxpayer takes them out of service for a finite period. However, equipment and facilities are not considered temporarily idle—

(*i*) During worker breaks, non-working hours, or on regularly scheduled non-working days (such as holidays or weekends);

(*ii*) During normal interruptions in the operation of the equipment or facilities;

(*iii*) When equipment is enroute to or located at a job site; or

(*iv*) When under normal operating conditions, the equipment is used or operated only during certain shifts.

(*2*) *Examples.* The provisions of this paragraph (e)(3)(iii)(E) are illustrated by the following examples:

Example 1. Equipment operated only during certain shifts. Taxpayer A manufactures widgets. Although A's manufacturing facility operates 24 hours each day in three shifts, A only operates its stamping machine during one shift each day. Because A only operates its stamping machine during certain shifts, A's stamping machine is not considered temporarily idle during the two shifts that it is not operated.

Example 2. Facility shut down for retooling. Taxpayer B owns and operates a manufacturing facility. B closes its manufacturing facility for two weeks to retool its assembly line. B's manufacturing facility is considered temporarily idle during this two-week period.

(F) *Taxes assessed on the basis of income.* Taxes assessed on the basis of income include only state, local, and foreign income taxes, and franchise taxes that are assessed on the taxpayer based on income.

(G) *Strike expenses.* Strike expenses include only costs associated with hiring employees to replace striking personnel (but not wages of replacement personnel), costs of security, and legal fees associated with settling strikes.

(H) *Warranty and product liability costs.* Warranty costs and product liability costs are costs incurred in fulfilling product warranty obligations for products that have been sold and costs incurred for product liability insurance.

(I) *On-site storage costs.* On-site storage costs are storage and warehousing costs incurred by a taxpayer at an on-site storage facility, as defined in §1.263A–3(c)(5)(ii)(A), with respect to property produced or property acquired for resale.

(J) *Unsuccessful bidding expenses.* Unsuccessful bidding costs are bidding expenses incurred in the solicitation of contracts not awarded to the taxpayer.

(K) *Deductible service costs.* Service costs that are not required to be capitalized include deductible service costs and deductible mixed service costs as defined in paragraph (e)(4) of this section.

(4) *Service costs*—(i) *Introduction.* This paragraph (e)(4) provides definitions and categories of service costs. Paragraph (g)(4) of this section provides specific rules for determining the amount of service costs allocable to property produced or property acquired for resale. In addition, paragraph (h) of this section provides a simplified method for determining the amount of service costs that must be capitalized.

(A) *Definition of service costs.* Service costs are defined as a type of indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

(B) *Definition of service departments.* Service departments are defined as administrative, service, or support departments that incur service costs. The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. For example, service departments include personnel, accounting, data processing, security, legal, and other similar departments.

(ii) *Various service cost categories*—(A) *Capitalizable service costs.* Capitalizable service costs are defined as service costs that directly benefit or are incurred by reason of the performance of the production or resale activities of the taxpayer. Therefore, these service costs are required to be capitalized under section 263A. Examples of service departments or functions that incur capitalizable service costs are provided in paragraph (e)(4)(iii) of this section.

(B) *Deductible service costs.* Deductible service costs are defined as service costs that do not directly benefit or are not incurred by reason of the performance of the production or resale activities of the taxpayer, and therefore, are not required to be capitalized under section 263A. Deductible service costs generally include costs incurred by reason of the taxpayer's overall management or policy guidance functions. In addition, deductible service costs include costs incurred by reason of the marketing, selling, advertising, and distribution activities of the taxpayer. Examples of service departments or functions that incur deductible service costs are provided in paragraph (e)(4)(iv) of this section.

(C) *Mixed service costs.* Mixed service costs are defined as service costs that are partially allocable to production or resale activities (capitalizable mixed service costs) and partially allocable to non-production or non-resale activities (deductible mixed service costs). For example, a personnel department may incur costs to recruit factory workers, the costs of which are allocable to production activities, and it may incur costs to develop wage, salary, and benefit policies, the costs of which are allocable to non-production activities.

(iii) *Examples of capitalizable service costs.* Costs incurred in the following departments or functions are generally allocated among production or resale activities:

(A) The administration and coordination of production or resale activities (wherever performed in the business organization of the taxpayer).

(B) Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records or employees.

(C) Purchasing operations, including purchasing materials and equipment, scheduling and coordinating delivery of materials and equipment to or from factories or job sites, and expediting and follow-up.

(D) Materials handling and warehousing and storage operations.

(E) Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions (but excluding accounts receivable and customer billing functions).

(F) Data processing.

(G) Security services.

(H) Legal services.

(iv) *Examples of deductible service costs.* Costs incurred in the following departments or functions are not generally allocated to production or resale activities:

(A) Departments or functions responsible for overall management of the taxpayer or for setting overall policy for all of the taxpayer's activities or trades or businesses, such as the board of directors (including their immediate staff), and the chief executive, financial, accounting, and legal officers (including their immediate staff) of the taxpayer, provided that no substantial part of the cost of such departments or functions benefits a particular production or resale activity.

(B) Strategic business planning.

(C) General financial accounting.

(D) General financial planning (including general budgeting) and financial management (including bank relations and cash management).

(E) Personnel policy (such as establishing and managing personnel policy in general; developing wage, salary, and benefit policies; developing employee training programs unrelated to particular production or resale activities; negotiating with labor unions; and maintaining relations with retired workers).

(F) Quality control policy.

(G) Safety engineering policy.

(H) Insurance or risk management policy (but not including bid or performance bonds or insurance related to activities associated with property produced or property acquired for resale).

(I) Environmental management policy (except to the extent that the costs of any system or procedure benefits a particular production or resale activity).

(J) General economic analysis and forecasting.

(K) Internal audit.

(L) Shareholder, public, and industrial relations.

(M) Tax services.

(N) Marketing, selling, or advertising.

(f) *Cost allocation methods*—(1) *Introduction.* This paragraph (f) sets forth various detailed or specific (facts-and-circumstances) cost allocation methods that taxpayers may use to allocate direct and indirect costs to property produced and property acquired for resale. Paragraph (g) of this section provides general rules for applying these allocation methods to various categories of costs (i.e., direct materials, direct labor, and indirect costs, including service costs). In addition, in lieu of a facts-and-circumstances allocation method, taxpayers may use the simplified methods provided in §§1.263A–2(b) and (c) and 1.263A–3(d) to allocate direct and indirect costs to eligible property produced or eligible property acquired for resale; see those sections for definitions of eligible property. Paragraph (h) of this section provides a simplified method for determining the amount of mixed service costs required to be capitalized to eligible property. The methodology set forth in paragraph (h) of this section for mixed service costs may be used in conjunction with either a facts-and-circumstances or a simplified method of allocating costs to eligible property produced or eligible property acquired for resale.

(2) *Specific identification method.* A specific identification method traces costs to a cost objective, such as a function, department, activity, or product, on the basis of a cause and effect or other reasonable relationship between the costs and the cost objective.

(3) *Burden rate and standard cost methods*—(i) *Burden rate method*—(A) *In general.* A burden rate method allocates an appropriate amount of indirect costs to property produced or property acquired for resale during a taxable year using predetermined rates that approximate the actual amount of indirect costs incurred by the taxpayer during the taxable year. Burden rates (such as ratios based on direct costs, hours, or similar items) may be developed by the taxpayer in accordance with acceptable accounting principles and applied in a reasonable manner. A taxpayer may allocate different indirect costs on the basis of different burden rates. Thus, for example, the taxpayer may use one burden rate for allocating the cost of rent and another burden rate for allocating the cost of utilities. Any periodic adjustment to a burden rate that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which such rates are developed, such as a change from basing the rates on direct labor hours to basing them on direct machine hours, is a change in

method of accounting to which section 446(e) applies.

(B) *Development of burden rates.* The following factors, among others, may be used in developing burden rates:

(*1*) The selection of an appropriate level of activity and a period of time upon which to base the calculation of rates reflecting operating conditions for purposes of the unit costs being determined.

(*2*) The selection of an appropriate statistical base, such as direct labor hours, direct labor dollars, machine hours, or a combination thereof, upon which to apply the overhead rate.

(*3*) The appropriate budgeting, classification, and analysis of expenses (for example, the analysis of fixed versus variable costs).

(C) *Operation of the burden rate method.* The purpose of the burden rate method is to allocate an appropriate amount of indirect costs to production or resale activities through the use of predetermined rates intended to approximate the actual amount of indirect costs incurred. Accordingly, the proper use of the burden rate method under this section requires that any net negative or net positive difference between the total predetermined amount of costs allocated to property and the total amount of indirect costs actually incurred and required to be allocated to such property (i.e., the under or over-applied burden) must be treated as an adjustment to the taxpayer's ending inventory or capital account (as the case may be) in the taxable year in which such difference arises. However, if such adjustment is not significant in amount in relation to the taxpayer's total indirect costs incurred with respect to production or resale activities for the year, such adjustment need not be allocated to the property produced or property acquired for resale unless such allocation is made in the taxpayer's financial statement. The taxpayer must treat both positive and negative adjustments consistently.

(ii) *Standard cost method*—(A) *In general.* A standard cost method allocates an appropriate amount of direct and indirect costs to property produced by the taxpayer through the use of preestablished standard allowances, without reference to costs actually incurred during the taxable year. A taxpayer may use a standard cost method to allocate costs, provided variances are treated in accordance with the procedures prescribed in paragraph (f)(3)(ii)(B) of this section. Any periodic adjustment to standard costs that merely reflects current operating conditions, such as increases in automation or changes in operation or prices, is not a change in method of accounting under section 446(e). A change, however, in the concept or base upon which standard costs are developed is a change in method of accounting to which section 446(e) applies.

(B) *Treatment of variances.* For purposes of this section, net positive overhead variance means the excess of total standard indirect costs over total actual indirect costs and net negative overhead variance means the excess of total actual indirect costs over total standard indirect costs. The proper use of a standard cost method requires that a taxpayer must reallocate to property a pro rata portion of any net negative or net positive overhead variances and any net negative or net positive direct cost variances. The taxpayer must apportion such variances to or among the property to which the costs are allocable. However, if such variances are not significant in amount relative to the taxpayer's total indirect costs incurred with respect to production and resale activities for the year, such variances need not be allocated to property produced or property acquired for resale unless such allocation is made in the taxpayer's financial statement. A taxpayer must treat both positive and negative variances consistently.

(4) *Reasonable allocation methods.* A taxpayer may use the methods described in paragraph (f) (2) or (3) of this section if they are reasonable allocation methods within the meaning of this paragraph (f)(4). In addition, a taxpayer may use any other reasonable method to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. An allocation method is reasonable if, with respect to the taxpayer's production or resale activities taken as a whole—

(i) The total costs actually capitalized during the taxable year do not differ significantly from the aggregate costs that would be properly capitalized using another permissible method described in this section or in §§ 1.263A–2 and 1.263A–3, with appropriate consideration given to the volume and value of the taxpayer's production or resale activities, the availability of costing information, the time and cost of using various allocation methods, and the accuracy of the allocation method chosen as compared with other allocation methods;

(ii) The allocation method is applied consistently by the taxpayer; and

(iii) The allocation method is not used to circumvent the requirements of the simplified methods in this section or in § 1.263A–2, § 1.263A–3, or the principles of section 263A.

(g) *Allocating categories of costs*—(1) *Direct materials*. Direct material costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year must be allocated to the property produced or property acquired for resale by the taxpayer using the taxpayer's d of accounting for materials (e.g., specific identification; first-in, first-out (FIFO); or last-in, first-out (LIFO)), or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(2) *Direct labor*. Direct labor costs (as defined in paragraph (e)(2) of this section) incurred during the taxable year are generally allocated to property produced or property acquired for resale using a specific identification method, standard cost method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section). All elements of compensation, other than basic compensation, may be grouped together and then allocated in proportion to the charge for basic compensation. Further, a taxpayer is not treated as using an erroneous method of accounting if direct labor costs are treated as indirect costs under the taxpayer's allocation method, provided such costs are capitalized to the extent required by paragraph (g)(3) of this section.

(3) *Indirect costs*. Indirect costs (as defined in paragraph (e)(3) of this section) are generally allocated to intermediate cost objectives such as departments or activities prior to the allocation of such costs to property produced or property acquired for resale. Indirect costs are allocated using either a specific identification method, a standard cost method, a burden rate method, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(4) *Service costs*—(i) *In general*. Service costs are a type of indirect costs that may be allocated using the same allocation methods available for allocating other indirect costs described in paragraph (g)(3) of this section. Generally, taxpayers that use a specific identification method or another reasonable allocation method must allocate service costs to particular departments or activities based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. For example, a reasonable factor for allocating legal services to particular departments or activities is the number of hours of legal services attributable to each department or activity. See paragraph (g)(4)(iv) of this section for other illustrations. Using reasonable factors or relationships, a taxpayer must allocate mixed service costs under a direct reallocation method described in paragraph (g)(4)(iii)(A) of this section, a step-allocation method described in paragraph (g)(4)(iii)(B) of this section, or any other reasonable allocation method (as defined under the principles of paragraph (f)(4) of this section).

(ii) *De minimis rule*. For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a taxpayer may elect not to allocate any portion of the service department's costs to property produced or property acquired for resale. For example, if 90 percent of the costs of an electing taxpayer's industrial relations department benefit the taxpayer's overall policy-making activities, the taxpayer is not required to allocate any portion of these costs to a production activity. Under this election, however, if 90 percent or more of a mixed service department's costs are capitalizable service costs, a taxpayer must allocate 100 percent of the department's costs to the production or resale activity benefitted. For example, if 90 percent of the costs of an electing taxpayer's accounting department benefit the taxpayer's manufacturing activity, the taxpayer must allocate 100 percent of the costs of the accounting department to the manufacturing activity. An election under this paragraph (g)(4)(ii) applies to all of a taxpayer's mixed service departments and constitutes the adoption of a (or a change in) method of accounting under section 446 of the Internal Revenue Code.

(iii) *Methods for allocating mixed service costs*—(A) *Direct reallocation method.* Under the direct reallocation method, the total costs (direct and indirect) of all mixed service departments are allocated only to departments or cost centers engaged in production or resale activities and then from those departments to particular activities. This direct reallocation method ignores benefits provided by one mixed service department to other mixed service departments, and also excludes other mixed service departments from the base used to make the allocation.

(B) *Step-allocation method.* (*1*) Under a step-allocation method, a sequence of allocations is made by the taxpayer. First, the total costs of the mixed service departments that benefit the greatest number of other departments are allocated to—

(*i*) Other mixed service departments;

(*ii*) Departments that incur only deductible service costs; and

(*iii*) Departments that exclusively engage in production or resale activities.

(*2*) A taxpayer continues allocating mixed service costs in the manner described in paragraph (g)(4)(iii)(B)(*1*) of this section (i.e., from the service departments benefitting the greatest number of departments to the service departments benefitting the least number of departments) until all mixed service costs are allocated to the types of departments listed in this paragraph (g)(4)(iii). Thus, a step-allocation method recognizes the benefits provided by one mixed service department to another mixed service department and also includes mixed service departments that have not yet been allocated in the base used to make the allocation.

(C) *Examples.* The provisions of this paragraph (g)(4)(iii) are illustrated by the following examples:

Example 1. Direct reallocation method. (i) Taxpayer E has the following five departments: the Assembling Department, the Painting Department, and the Finishing Department (production departments), and the Personnel Department and the Data Processing Department (mixed service departments). E allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours.

(ii) Under a direct reallocation method, E allocates the Personnel Department's costs directly to its Assembling, Painting, and Finishing Department, and not to its Data Processing department.

Department	Total dept. costs	Amount of payroll costs	Allocation ratio	Amount allocated
Personnel	$500,000	$50,000	....	<$500,000>
Data Proc'g	250,000	15,000		
Assembling	250,000	15,000	15,000/285,000	26,315
Painting	1,000,000	90,000	90,000/285,000	157,895
Finishing	2,000,000	180,000	180,000/285,000	315,790
Total	$4,000,000	$350,000		

(iii) After E allocates the Personnel Department's costs, E then allocates the costs of its Data Processing Department in the same manner.

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation ratio	Amount allocated	Total dept. cost after final allocation
Personnel	0	2,000	....	....	0
Data Proc'g	$250,000	....	....	<$250,000>	....

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation ratio	Amount allocated	Total dept. cost after final allocation
Assembling	276,315	2,000	2,000/10,000	50,000	$326,315
Painting	1,157,895	0	0/10,000	0	1,157,895
Finishing	2,315,790	8,000	8,000/10,000	200,000	2,515,790
Total	$4,000,000	12,000			$4,000,000

Example 2. Step-allocation method. (i) Taxpayer F has the following five departments: the Manufacturing Department (a production department), the Marketing Department and the Finance Department (departments that incur only deductible service costs), the Personnel Department and the Data Processing Department (mixed service departments). F uses a step-allocation method and allocates the Personnel Department's costs on the basis of total payroll costs and the Data Processing Department's costs on the basis of data processing hours. F's Personnel Department benefits all four of F's other departments, while its Data Processing Department benefits only three departments. Because F's Personnel Department benefits the greatest number of other departments, F first allocates its Personnel Department's costs to its Manufacturing, Marketing, Finance and Data Processing departments, as follows:

Department	Total cost of dept.	Total payroll costs	Allocation ratio	Amount allocated
Personnel	$500,000	$50,000		<$500,000>
Data Proc'g	250,000	15,000	15,000/300,000	25,000
Finance	250,000	15,000	15,000/300,000	25,000
Marketing	1,000,000	90,000	90,000/300,000	150,000
Manufac'g	2,000,000	180,000	180,000/300,000	300,000
	4,000,000	350,000		

(ii) Under a step-allocation method, the denominator of F's allocation ratio includes the payroll costs of its Manufacturing, Marketing, Finance, and Data Processing departments.

(iii) Next, F allocates the costs of its Data Processing Department on the basis of data processing hours. Because the costs incurred by F's Personnel Department have already been allocated, no allocation is made to the Personnel Department.

Department	Total dept. cost after initial allocation	Total data proc. hours	Allocation		
ratio.					
Personnel	$0	2,000			$0
Data Proc'g	275,000			<$275,000>	0
Finance	275,000	2,000	2,000/10,000	55,000	330,000
Marketing	1,150,000	0	0/10,000	0	1,150,000
Manufac'g	2,300,000	8,000	8,000/10,000	220,000	2,520,000
	4,000,000	12,000			4,000,000

(iv) Under the second step of F's step-allocation method, the denominator of F's allocation ratio includes the data processing hours of its Manufacturing, Marketing, and Finance Departments, but does not include the data processing hours of its Personnel Department (the other mixed service department) because the costs of that department have previously been allocated.

(iv) *Illustrations of mixed service cost allocations using reasonable factors or relationships.* This paragraph (g)(4)(iv) illustrates various reasonable factors and relationships that may be used in allocating different types of mixed service costs. Taxpayers, however, are permitted to use other reasonable factors and relationships to allocate mixed service costs. In addition, the factors or relationships illustrated in this paragraph (g)(4)(iv) may be used to allocate other types of service costs not illustrated in this paragraph (g)(4)(iv).

(A) *Security services.* The costs of security or protection services must be allocated to each physical area that receives the services using any reasonable method applied consistently (e.g., the size of the physical area, the number of employees in the area, or the relative fair market value of assets located in the area).

(B) *Legal services.* The costs of legal services are generally allocable to a particular production or resale activity on the basis of the approximate number of hours of legal service performed in connection with the activity, including research, bidding, negotiating, drafting, reviewing a contract, obtaining necessary licenses and permits, and resolving disputes. Different hourly rates may be appropriate for different services. In determining the number of hours allocable to any activity, estimates are appropriate, detailed time records are not required to be kept, and insubstantial amounts of services provided to an activity by senior legal staff (such as administrators or reviewers) may be ignored. Legal costs may also be allocated to a particular production or resale activity based on the ratio of the total direct costs incurred for the activity to the total direct costs incurred with respect to all production or resale activities. The taxpayer must also allocate directly to an activity the cost incurred for any outside legal services. Legal costs relating to general corporate functions are not required to be allocated to a particular production or resale activity.

(C) *Centralized payroll services.* The costs of a centralized payroll department or activity are generally allocated to the departments or activities benefitted on the basis of the gross dollar amount of payroll processed.

(D) *Centralized data processing services.* The costs of a centralized data processing department are generally allocated to all departments or activities benefitted using any reasonable basis, such as total direct data processing costs or the number of data processing hours supplied. The costs of data processing systems or applications developed for a particular activity are directly allocated to that activity.

(E) *Engineering and design services.* The costs of an engineering or a design department are generally directly allocable to the departments or activities benefitted based on the ratio of the approximate number of hours of work performed with respect to the particular activity to the total number of hours of engineering or design work performed for all activities. Different services may be allocated at different hourly rates.

(F) *Safety engineering services.* The costs of a safety engineering departments or activities generally benefit all of the taxpayer's activities and, thus, should be allocated using a reasonable basis, such as: the approximate number of safety inspections made in connection with a particular activity as a fraction of total inspections, the number of employees assigned to an activity as a fraction of total employees, or the total labor hours worked in connection with an activity as a fraction of total hours. However, in determining the allocable costs of a safety engineering department, costs attributable to providing a safety program relating only to a particular activity must be directly assigned to such activity. Additionally, the cost of a safety engineering department only responsible for setting safety policy and establishing safety procedures to be used in all of the taxpayer's activities is not required to be allocated.

(v) *Accounting method change.* A change in the method or base used to allocate service costs (such as changing from an allocation base using direct labor costs to a base using direct labor hours), or a change in the taxpayer's determination of what functions or departments of the taxpayer are to be allocated, is a change in method of accounting to which section 446(e) and the regulations thereunder apply.

(h) *Simplified service cost method*—(1) *Introduction.* This paragraph (h) provides a simplified method for determining capitalizable mixed service costs incurred during the taxable year with respect to eligible property (i.e., the aggregate portion of mixed service costs that are properly allocable to the taxpayer's production or resale activities).

(2) *Eligible property*—(i) *In general*. Except as otherwise provided in paragraph (h)(2)(ii) of this section, the simplified service cost method, if elected for any trade or business of the taxpayer, must be used for all production and resale activities of the trade or business associated with any of the following categories of property that are subject to section 263A:

(A) *Inventory property*. Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale*. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets*. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed tangible personal property produced on a routine and repetitive basis—(1) In general*. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A–10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (h)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46–3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (h)(2)(i)(D).

(2) *Examples*. The following examples illustrate this paragraph (h)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(ii) *Election to exclude self-constructed assets*. At the taxpayer's election, the simplified service cost method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (h)(2)(i)(A) and(B) of this section. Taxpayers electing to exclude the self-constructed assets described in paragraphs (h)(2)(i)(C) and (D) of this section from application of the simplified service cost method must, however, allocate service costs to such property in accordance with paragraph (g)(4) of this section.

(3) *General allocation formula*. (i) Under the simplified service cost method, a taxpayer computes its capitalizable mixed service costs using the following formula:

$$\text{Allocation ratio} \times \text{total mixed service costs}$$

(ii) A producer may elect one of two allocation ratios, the labor-based allocation ratio or the production cost allocation ratio. A reseller that satisfies the requirements for using the simplified resale method of §1.263A–3(d) (whether or not that method is elected) may elect the simplified service cost method, but must use a labor-based allocation ratio. (See §1.263A–3(d) for labor-based allocation ratios to be used in conjunction with the simplified resale method.) The allocation ratio used by a trade or business of a taxpayer is a method of accounting which must be applied consistently within the trade or business.

(4) *Labor-based allocation ratio.* (i) The labor-based allocation ratio is computed as follows:

$$\frac{\text{Section 263A labor costs}}{\text{Total labor costs}}$$

(ii) Section 263A labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) allocable to property produced and property acquired for resale under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) incurred in the taxpayer's trade or business during the taxable year. Total labor costs include labor costs incurred in all parts of the trade or business (i.e., if the taxpayer has both property produced and property acquired for resale, the taxpayer must include labor costs from resale activities as well as production activities). For example, taxpayer G incurs $1,000 of total mixed service costs during the taxable year. G's section 263A labor costs are $5,000 and its total labor costs are $10,000. Under the labor-based allocation ratio, G's capitalizable mixed service costs are $500 (i.e., $1,000 × ($5,000 divided by $10,000)).

(5) *Production cost allocation ratio.* (i) Producers may use the production cost allocation ratio, computed as follows:

$$\frac{\text{Section 263A production costs}}{\text{Total costs}}$$

(ii) Section 263A production costs are defined as the total costs (excluding mixed service costs and interest) allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) under section 263A that are incurred in the taxpayer's trade or business during the taxable year. Total costs are defined as all costs (excluding mixed service costs and interest) incurred in the taxpayer's trade or business during the taxable year. Total costs include all direct and indirect costs allocable to property produced (and property acquired for resale if the producer is also engaged in resale activities) as well as all other costs of the taxpayer's trade or business, including, but not limited to: salaries and other labor costs of all personnel; all depreciation taken for federal income tax purposes; research and experimental expenditures; and selling, marketing, and distribution costs. Such costs do not include, however, taxes described in paragraph (e)(3)(iii)(F) of this section. For example, taxpayer H, a producer, incurs $1,000 of total mixed service costs in the taxable year. H's section 263A production costs are $10,000 and its total costs are $20,000. Under the production cost allocation ratio, H's capitalizable mixed service costs are $500 (i.e., $1,000 × ($10,000 divided by $20,000)).

(6) *Definition of total mixed service costs.* Total mixed service costs are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. See paragraph (e)(4)(ii)(C) of this section which defines mixed service costs. In determining the total mixed service costs of a trade or business, the taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. For example, if the accounting department within a trade or business is a mixed

service department, then in determining the total mixed service costs of the trade or business, the taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs.

(7) *Costs allocable to more than one business.* To the extent mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with the principles of paragraph (f)(4) of this section.

(8) *De minimis rule.* If the taxpayer elects to apply the de minimis rule of paragraph (g)(4)(ii) of this section to any mixed service department, the department is not considered a mixed service department for purposes of the simplified service cost method. Instead, the costs of such department are allocated exclusively to the particular activity satisfying the 90-percent test.

(9) *Separate election.* A taxpayer may elect the simplified service cost method in conjunction with any other allocation method used at the trade or business level, including the simplified methods described in §§ 1.263A–2(b) and (c) and 1.263A–3(d). However, the election of the simplified service cost method must be made independently of the election to use those other simplified methods.

(i) [Reserved]

(j) *Exemption for certain small business taxpayers*—(1) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test under section 448(c) and § 1.448–2(c) (section 448(c) gross receipts test) for any taxable year (small business taxpayer) is not required to capitalize costs under section 263A to any real or tangible personal property produced, and any real or personal property described in section 1221(a)(1) acquired for resale, during that taxable year. This section 448(c) gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(2) *Application of the section 448(c) gross receipts test*—(i) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (j)(2)(ii) and (iii) of this section, the section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(iii) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share, as determined under section 704, of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(iv) *Examples.* The operation of this paragraph (j) is illustrated by the following examples:

(A) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business,* of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(B) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

(3) *Change in method of accounting*—(i) *In general.* A change from applying the small business taxpayer exemption under paragraph (j) of this section to not applying the exemption under this paragraph (j), or *vice versa,* is a change in method of accounting under section 446(e) and §1.446–1(e). A taxpayer changing its method of accounting under paragraph (j) of this section may do so only with the consent of the Commissioner as required under section 446(e) and §1.446–1. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446–1. The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under §1.446–1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter).

(ii) *Automatic consent for certain method changes.* Certain changes in method of accounting made under paragraph (j) of this section may be made under the procedures to obtain the automatic consent of the Commissioner to change a method of accounting. See Revenue Procedure 2015–13 (2015–5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter)). In certain situations, special terms and conditions may apply.

(k) *Special rules*—(1) *Costs provided by a related person*—(i) *In general.* A taxpayer subject to section 263A must capitalize an arm's-length charge for any section 263A costs (e.g., costs of materials, labor, or services) incurred by a related person that are properly allocable to the property produced or property acquired for resale by the taxpayer. Both the taxpayer and the related person must account for the transaction as if an arm's-length charge had been incurred by the taxpayer with respect to its property produced or property acquired for resale. For purposes of this paragraph (j)(1)(i), a taxpayer is considered related to another person if the taxpayer and such person are described in section 482. Further, for purposes of this paragraph (j)(1)(i), arm's-length charge means the arm's-length charge (or other appropriate charge where permitted and applicable) under the principles of section 482. Any correlative adjustments necessary because of the arm's-length charge requirement of this paragraph (j)(1)(i) shall be determined under the principles of section 482.

(ii) *Exceptions.* The provisions of paragraph (j)(1)(i) of this section do not apply if, and to the extent that—

(A) It would be inappropriate under the principles of section 482 for the Commissioner to adjust the income of the taxpayer or the related person with respect to the transaction at issue; or

(B) A transaction is accounted for under an alternative Internal Revenue Code section resulting in the capitalization (or deferral of the deduction) of the costs of the items provided by the related party and the related party does not deduct such costs earlier than the costs would have been deducted by the taxpayer if the costs were capitalized under section 263A. See §1.1502–13.

(2) *Optional capitalization of period costs*—(i) *In general.* Taxpayers are not required to capitalize indirect costs that do not directly benefit or are not incurred by reason of the production of property or acquisition of property for resale (i.e., period costs). A taxpayer may, however, elect to capitalize certain period costs if: The method is consistently applied; is used in computing beginning inventories, ending inventories, and cost of goods sold; and does not result in a material distortion of the taxpayer's income. A material distortion relates to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization of the cost. Thus, for example, a taxpayer may not capitalize a period cost under section 263A if capitalization would result in a material change in the computation of the foreign tax credit limitation under section 904. An election to capitalize a period cost is the adoption of (or a change in) a method of accounting under section 446 of the Internal Revenue Code.

(ii) *Period costs eligible for capitalization.* The types of period costs eligible for capitalization under this paragraph (j)(2) include only the types of period costs (e.g., under paragraph (e)(3)(iii) of this section) for which some portion of the costs incurred is properly allocable to property produced or property acquired for resale in the year of the election. Thus, for example, marketing or advertising costs, no portion of which are properly allocable to property produced or property acquired for resale, do not qualify for elective capitalization under this paragraph (j)(2).

(3) *Trade or business application.* Notwithstanding the references generally to taxpayer throughout this section and §§1.263A–2 and 1.263A–3, the methods of accounting provided under section 263A are to be elected and applied independently for each separate and distinct trade or business of the taxpayer in accordance with the provisions of section 446(d) and the regulations thereunder.

(4) *Transfers with a principal purpose of tax avoidance.* The District Director may require appropriate adjustments to valuations of inventory and other property subject to section 263A if a transfer of property is made to another person for a principal purpose of avoiding the application of section 263A. Thus, for example, the District Director may require a taxpayer using the simplified production method of §1.263A–2(b) to apply that method to transferred inventories immediately prior to a transfer under section 351 if a principal purpose of the transfer is to avoid the application of section 263A.

(l) *Change in method of accounting*—(1) *In general.* A change in a taxpayer's treatment of mixed service costs to comply with paragraph (h)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under those sections apply. See §1.263A–7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (4) of this section, issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 CB 327), as modified and clarified by Announcement 2002–17 (2002–1 CB 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), and amplified, clarified, and modified by Rev. Proc. 2002–54 (2002–2 CB 432), and §601.601(d)(2)(ii)(*b*) of this chapter). For purposes of Form 3115, "Application for Change in Accounting Method," the designated number for the automatic accounting method change authorized by this paragraph (k) is "95." If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. Alternatively, notwithstanding the provisions of any administrative procedures that preclude a taxpayer from requesting the advance consent of the Commissioner to change a method of accounting that is required to be made pursuant to a published automatic change procedure, for its first taxable year ending on or after August 2, 2005, a taxpayer may request the advance consent of the Commissioner to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (k)(2) through (5) of this section, for obtaining the advance consent of the Commissioner (for further guidance, for example, see Rev. Proc. 97–27 (1997–1 CB 680), as modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), as amplified and clarified by Rev. Proc. 2002–54 (2002–2 CB 432), and §601.601(d)(2)(ii)(*b*) of this chapter). For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (k)(3) and (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method.

(2) *Scope limitations.* Any limitations on obtaining the automatic consent or advance consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005.

(3) *Audit protection.* A taxpayer that changes its method of accounting in accordance with this paragraph (k) to comply with paragraph (h)(2)(i)(D) of this section does not receive audit protection if its method of accounting for mixed service costs is an issue under consideration at the time the application is filed with the national office.

(4) *Section 481(a) adjustment.* A change in method of accounting to conform to paragraph (h)(2)(i)(D) of this section requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to paragraph (h)(2)(i)(D) of this section.

(5) *Time for requesting change.* Notwithstanding the provisions of §1.446–1(e)(3)(i) and any contrary administrative procedure, a taxpayer may submit a request for advance consent to change its method of accounting to comply with paragraph (h)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005, on or before the date that is 30 days after the end of the taxable year for which the change is requested.

(m) *Effective/applicability date*—(1) *In general.* Except as provided in (l)(2), (l)(3), and (l)(4) of this section, the effective dates for this section are provided in paragraph (a)(2) of this section.

(2) *Mixed service costs; self-constructed tangible personal property produced on a routine and repetitive basis.* Paragraphs (h)(2)(i)(D), (k), and (l)(2) of this section apply for taxable years ending on or after August 2, 2005.

(3) *Costs allocable to property sold; indirect costs; licensing and franchise costs.* Paragraphs (c)(5), (e)(3)(i), and (e)(3)(ii)(U) of this section apply for taxable years ending on or after January 13, 2014.

(4) *Materials and supplies*—(i) *In general.* The last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section apply to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2014.

(ii) *Early application of this section.* A taxpayer may choose to apply the last sentence of paragraphs (e)(2)(i)(A) and (e)(3)(ii)(E) of this section, and paragraph (l)(4) of this section to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply §1.263A–1T(b)(14), the introductory phrase of §1.263A–1T(c)(4), the last sentence of §1.263A–1T(e)(2)(i)(A), the last sentence of §1.263A–1T(e)(3)(ii)(E), §1.263A–1T(l), and §1.263A–1T(m)(2), as these provisions are contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014.

(5) *Definitions of section 471 costs and additional section 263A costs.* Paragraphs (d)(2) and (3) of this section apply for taxable years beginning on or after November 20, 2018. For any taxable year that both begins before November 20,

2018 and ends after November 20, 2018, the IRS will not challenge return positions consistent with all of paragraphs (d)(2) and (3) of this section.

(6) *Exemption for certain small business taxpayers.* The second and third sentence in paragraph (a)(2)(i), paragraphs (b)(1) and (j) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (m)(6), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

[T.D. 8482, 58 FR 42209, Aug. 9, 1993]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.263A–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

§ 1.263A–2 Rules relating to property produced by the taxpayer.

(a) *In general.* Section 263A applies to real property and tangible personal property produced by a taxpayer for use in its trade or business or for sale to its customers. In addition, section 263A applies to property produced for a taxpayer under a contract with another party. The principal terms related to the scope of section 263A with respect to producers are provided in this paragraph (a). See §1.263A–1(b)(11) for an exception in the case of certain de minimis property provided to customers incident to the provision of services. For taxable years beginning after December 31, 2017, see §1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448–2(c).

(1) *Produce*—(i) *In general.* For purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow.

(ii) *Ownership*—(A) *General rule.* Except as provided in paragraphs (a)(1)(ii)(B) and (C) of this section, a taxpayer is not considered to be producing property unless the taxpayer is considered an owner of the property produced under federal income tax principles. The determination as to whether a taxpayer is an owner is based on all of the facts and circumstances, including the various benefits and burdens of ownership vested with the taxpayer. A taxpayer may be considered an owner of property produced, even though the taxpayer does not have legal title to the property.

(B) *Property produced for the taxpayer under a contract*—(*1*) *In general.* Property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. A taxpayer has made payment under this section if the transaction would be considered payment by a taxpayer using the cash receipts and disbursements method of accounting.

(*2*) *Definition of a contract*—(*i*) *General rule.* Except as provided under paragraph (a)(1)(ii)(B)(*2*)(*ii*) of this section, a contract is any agreement providing for the production of property if the agreement is entered into before the production of the property to be delivered under the contract is completed. Whether an agreement exists depends on all the facts and circumstances. Facts and circumstances indicating an agreement include, for example, the making of a prepayment, or an arrangement to make a prepayment, for property prior to the date of the completion of production of the property, or the incurring of significant expenditures for property of specialized design or specialized application that is not intended for self-use.

(*ii*) *Routine purchase order exception.* A routine purchase order for fungible property is not treated as a contract for purposes of this section. An agreement will not be treated as a routine purchase order for fungible property, however, if the contractor is required to make more than de minimis modifications to the property to tailor it to the customer's specific needs, or if at the time the agreement is entered into, the customer knows or has reason to know that the contractor cannot satisfy the agreement within 30 days out of existing stocks and normal production of finished goods.

(C) Home construction contracts. Section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date, and, for contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017, the taxpayer meets the gross receipts test of section 448(c) and § 1.448–2(c) for the taxable year in which such contract is entered into. Except as otherwise provided in this paragraph (a)(1)(ii)(C), section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under Federal income tax principles.

(2) *Tangible personal property*—(i) *General rule.* In general, section 263A applies to the costs of producing tangible personal property, and not to the costs of producing intangible property. For example, section 263A applies to the costs manufacturers incur to produce goods, but does not apply to the costs financial institutions incur to originate loans.

(ii) *Intellectual or creative property.* For purposes of determining whether a taxpayer producing intellectual or creative property is producing tangible personal property or intangible property, the term tangible personal property includes films, sound recordings, video tapes, books, and other similar property embodying words, ideas, concepts, images, or sounds by the creator thereof. Other similar property for this purpose generally means intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered. However, any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator is not other similar property for these purposes.

(A) *Intellectual or creative property that is tangible personal property.* Section 263A applies to tangible personal property defined in this paragraph (a)(2) without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, for example, section 263A applies to the costs of producing a motion picture or researching and writing a book even though these assets may be considered intangible for other purposes of the Internal Revenue Code. Tangible personal property includes, for example, the following:

(*1*) *Books.* The costs of producing and developing books (including teaching aids and other literary works) required to be capitalized under this section include costs incurred by an author in researching, preparing, and writing the book. (However, see section 263A(h), which provides an exemption from the capitalization requirements of section 263A in the case of certain free-lance authors.) In addition, the costs of producing and developing books include prepublication expenditures incurred by publishers, including payments made to authors (other than commissions for sales of books that have already taken place), as well as costs incurred by publishers in writing, editing, compiling, illustrating, designing, and developing the books. The costs of producing a book also include the costs of producing the underlying manuscript, copyright, or license. (These costs are distinguished from the separately capitalizable costs of printing and binding the tangible medium embodying the book (e.g., paper and ink).) See § 1.174–2(a)(1), which provides that the term research or experimental expenditures does not include expenditures incurred for research in connection with literary, historical, or similar projects.

(*2*) *Sound recordings.* A sound recording is a work that results from the fixation of a series of musical, spoken, or other sounds, regardless of the nature of the material objects, such as discs, tapes, or other phonorecordings, in which such sounds are embodied.

(B) *Intellectual or creative property that is not tangible personal property.* Items that are not considered tangible personal property within the meaning of section 263A(b) and paragraph (a)(2)(ii) of this section include:

(*1*) *Evidences of value.* Tangible personal property does not include property that is representative or evidence of value, such as stock, securities, debt instruments, mortgages, or loans.

(*2*) *Property provided incident to services.* Tangible personal property does not include de minimis property provided to a client or customer incident to the provision of services, such as wills prepared by attorneys, or blueprints prepared by architects. See §1.263A–1(b)(11).

(3) *Costs required to be capitalized by producers*—(i) *In general.* Except as specifically provided in section 263A(f) with respect to interest costs, producers must capitalize direct and indirect costs properly allocable to property produced under section 263A, without regard to whether those costs are incurred before, during, or after the production period (as defined in section 263A(f)(4)(B)).

(ii) *Pre-production costs.* If property is held for future production, taxpayers must capitalize direct and indirect costs allocable to such property (e.g., purchasing, storage, handling, and other costs), even though production has not begun. If property is not held for production, indirect costs incurred prior to the beginning of the production period must be allocated to the property and capitalized if, at the time the costs are incurred, it is reasonably likely that production will occur at some future date. Thus, for example, a manufacturer must capitalize the costs of storing and handling raw materials before the raw materials are committed to production. In addition, a real estate developer must capitalize property taxes incurred with respect to property if, at the time the taxes are incurred, it is reasonably likely that the property will be subsequently developed.

(iii) *Post-production costs.* Generally, producers must capitalize all indirect costs incurred subsequent to completion of production that are properly allocable to the property produced. Thus, for example, storage and handling costs incurred while holding the property produced for sale after production must be capitalized to the property to the extent properly allocable to the property. However, see §1.263A–3(c) for exceptions.

(4) *Practical capacity concept.* Notwithstanding any provision to the contrary, the use, directly or indirectly, of the practical capacity concept is not permitted under section 263A. For purposes of section 263A, the term practical capacity concept means any concept, method, procedure, or formula (such as the practical capacity concept described in §1.471–11(d)(4)) whereunder fixed costs are not capitalized because of the relationship between the actual production at the taxpayer's production facility and the practical capacity of the facility. For purposes of this section, the practical capacity of a facility includes either the practical capacity or theoretical capacity of the facility, as defined in §1.471–11(d)(4), or any similar determination of productive or operating capacity. The practical capacity concept may not be used with respect to any activity to which section 263A applies (i.e., production or resale activities). A taxpayer shall not be considered to be using the practical capacity concept solely because the taxpayer properly does not capitalize costs described in §1.263A–1(e)(3)(iii)(E), relating to certain costs attributable to temporarily idle equipment.

(5) *Taxpayers required to capitalize costs under this section.* This section generally applies to taxpayers that produce property. If a taxpayer is engaged in both production activities and resale activities, the taxpayer applies the principles of this section as if it read production or resale activities, and by applying appropriate principles from §1.263A–3. If a taxpayer is engaged in both production and resale activities, the taxpayer may elect the simplified production method or the modified simplified production method provided in this section, but generally may not elect the simplified resale method discussed in §1.263A–3(d). If elected, the simplified production method or the modified simplified production method must be applied to all eligible property produced and all eligible property acquired for resale by the taxpayer.

(b) *Simplified production method*—(1) *Introduction*. This paragraph (b) provides a simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) *Eligible property*—(i) *In general*. Except as otherwise provided in paragraph (b)(2)(ii) of this section, the simplified production method, if elected for any trade or business of a producer, must be used for all production and resale activities associated with any of the following categories of property to which section 263A applies:

(A) *Inventory property*. Stock in trade or other property properly includible in the inventory of the taxpayer.

(B) *Non-inventory property held for sale*. Non-inventory property held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(C) *Certain self-constructed assets*. Self-constructed assets substantially identical in nature to, and produced in the same manner as, inventory property produced by the taxpayer or other property produced by the taxpayer and held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(D) *Self-constructed tangible personal property produced on a routine and repetitive basis—(1) In general*. Self-constructed tangible personal property produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business. Self-constructed tangible personal property is produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business when units of tangible personal property (as defined in §1.263A–10(c)) are mass-produced, that is, numerous substantially identical assets are manufactured within a taxable year using standardized designs and assembly line techniques, and either the applicable recovery period of the property determined under section 168(c) is not longer than 3 years or the property is a material or supply that will be used and consumed within 3 years of being produced. For purposes of this paragraph (b)(2)(i)(D), the applicable recovery period of the assets will be determined at the end of the taxable year in which the assets are placed in service for purposes of §1.46–3(d). Subsequent changes to the applicable recovery period after the assets are placed in service will not affect the determination of whether the assets are produced on a routine and repetitive basis for purposes of this paragraph (b)(2)(i)(D).

(2) *Examples*. The following examples illustrate this paragraph (b)(2)(i)(D):

Example 1. Y is a manufacturer of automobiles. During the taxable year Y produces numerous substantially identical dies and molds using standardized designs and assembly line techniques. The dies and molds have a 3-year applicable recovery period for purposes of section 168(c). Y uses the dies and molds to produce or process particular automobile components and does not hold them for sale. The dies and molds are produced on a routine and repetitive basis in the ordinary course of Y's business for purposes of this paragraph because the dies and molds are both mass-produced and have a recovery period of not longer than 3 years.

Example 2. Z is an electric utility that regularly manufactures and installs identical poles that are used in transmitting and distributing electricity. The poles have a 20-year applicable recovery period for purposes of section 168(c). The poles are not produced on a routine and repetitive basis in the ordinary course of Z's business for purposes of this paragraph because the poles have an applicable recovery period that is longer than 3 years.

(ii) *Election to exclude self-constructed assets*. At the taxpayer's election, the simplified production method may be applied within a trade or business to only the categories of inventory property and non-inventory property held for sale described in paragraphs (b)(2)(i) (A) and (B) of this section. Taxpayers electing to exclude the self- constructed assets, defined in paragraphs (b)(2)(i) (C) and (D) of this section, from application of the simplified production method must, however, allocate additional section 263A costs to such property in accordance with §1.263A–1 (f).

(3) *Simplified production method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general*. Except as otherwise provided in paragraph (b)(3)(iv) of this section, the additional section 263A costs allocable

to eligible property remaining on hand at the close of the taxable year under the simplified production method are computed as follows:

$$\text{Absorption ratio} \times \text{section 471 costs remaining on hand at year end}$$

(B) *Effect of allocation.* The absorption ratio generally is multiplied by the section 471 costs remaining in ending inventory or otherwise on hand at the end of each taxable year in which the simplified production method is applied. The resulting product is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (b)(3)(iii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified production method of this paragraph (b) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) *Definitions*—(A) *Absorption ratio.* Under the simplified production method, the absorption ratio is determined as follows:

$$\frac{\text{Additional section 263A costs incurred during the taxable year}}{\text{Section 471 costs incurred during the taxable year}}$$

(*1*) *Additional section 263A costs incurred during the taxable year.* Additional section 263A costs incurred during the taxable year are defined as the additional section 263A costs described in §1.263A–1(d)(3) that a taxpayer incurs during its current taxable year.

(*2*) *Section 471 costs incurred during the taxable year.* Section 471 costs incurred during the taxable year are defined as the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs during its current taxable year.

(B) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end means the section 471 costs, as defined in §1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (b)(3)(iii) of this section.

(C) *Costs allocated to property sold.* Additional section 263A costs incurred during the taxable year, as defined in paragraph (b)(3)(ii)(A)(*1*) of this section, section 471 costs incurred during the taxable year, as defined in paragraph (b)(3)(ii)(A)(*2*) of this section, and section 471 costs remaining on hand at year end, as defined in paragraph (b)(3)(ii)(B) of this section, do not include costs described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(iii) *LIFO taxpayers electing the simplified production method*—(A) *In general.* Under the simplified production method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under §1.472–8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment.* If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section

471 costs). The taxpayer then multiplies this amount by the absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement.* If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iv) *De minimis rule for producers with total indirect costs of $200,000 or less*—(A) *In general.* If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero. Solely for purposes of this paragraph (b)(3)(iv), taxpayers are permitted to exclude any category of indirect costs (listed in §1.263A–1(e)(3)(iii)) that is not required to be capitalized (e.g., selling and distribution costs) in determining total indirect costs.

(B) *Related party and aggregation rules.* In determining whether the producer incurs $200,000 or less of total indirect costs in a taxable year, the related party and aggregation rules of §1.263A–3(b)(3) are applied by substituting total indirect costs for gross receipts wherever gross receipts appears.

(v) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. FIFO inventory method. (i) Taxpayer J uses the FIFO method of accounting for inventories. J's beginning inventory for 1994 (all of which is sold during 1994) is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, J incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. J's additional section 263A costs include capitalizable mixed service costs computed under the simplified service cost method as well as other allocable costs. J's section 471 costs remaining in ending inventory at the end of 1994 are $3,000,000. J computes its absorption ratio for 1994, as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1{,}000{,}000}{\$10{,}000{,}000} = 10\%$$

(ii) Under the simplified production method, J determines the additional section 263A costs allocable to its ending inventory by multiplying the absorption ratio by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 10\% \times \$3{,}000{,}000 = \$300{,}000$$

(iii) J adds this $300,000 to the $3,000,000 of section 471 costs remaining in its ending inventory to calculate its total ending inventory of $3,300,000. The balance of J's additional section 263A costs incurred during 1994, $700,000, ($1,000,000 less $300,000) is taken into account in 1994 as part of J's cost of goods sold.

Example 2. LIFO inventory method. (i) Taxpayer K uses a dollar-value LIFO inventory method. K's beginning inventory for 1994 is $2,500,000 (consisting of $2,000,000 of section 471 costs and $500,000 of additional section 263A costs). During 1994, K incurs $10,000,000 of section 471 costs and $1,000,000 of additional section 263A costs. K's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) To determine the additional section 263A costs allocable to its ending inventory, K multiplies the 10% absorption ratio ($1,000,000 of additional section 263A costs divided by $10,000,000 of section 471 costs) by the $1,000,000 LIFO increment. Thus, K's additional section 263A costs allocable to its ending inventory are $100,000 ($1,000,000 multiplied by 10%). This $100,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,100,000. K's ending inventory is $3,600,000 (its beginning inventory of $2,500,000 plus the $1,100,000 increment). The balance of K's additional section 263A costs incurred during 1994, $900,000 ($1,000,000 less $100,000), is taken into account in 1994 as part of K's cost of goods sold.

(iii) In 1995, K sells one-half of the inventory in its 1994 LIFO increment. K must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, $50,000 (one-half of the tional section 263A costs capitalized in 1994 ending inventory, or $100,000).

Example 3. LIFO pools. (i) Taxpayer U begins its business in 1994 and adopts the LIFO inventory method. During 1994, L incurs $10,000 of section 471 costs and $1,000 of additional section 263A costs. At the end of 1994, L's ending inventory includes $3,000 of section 471 costs contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified production method, L computes its absorption ratio and inventory for 1994 as follows:

$$\frac{\text{Additional section 263A costs incurred during 1994}}{\text{Section 471 costs incurred during 1994}} = \frac{\$1,000}{\$10,000} = 10\%$$

	Total	X	Y	Z
1994:				
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	$3,300	$1,760	$660	$880

(ii) During 1995, L incurs $2,000 of section 471 costs as shown below and $400 of additional section 263A costs. Moreover, L sells goods from pools X, Y, and Z having a total cost of $1,000. L computes its absorption ratio and inventory for 1995:

$$\frac{\text{Additional section 263A costs incurred during 1995}}{\text{Section 471 costs incurred during 1995}} = \frac{\$400}{\$2,000} = 20\%$$

	Total	X	Y	Z
1995:				
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending section 471 costs	$4,000	$2,800	$600	$600
Consisting of:				
1994 layer	$2,800	$1,600	$600	$600
1995 layer	1,200	1,200	....	....
	$4,000	$2,800	$600	$600
Additional section 263A costs:				
1994 (10%)	$280	$160	$60	$60
1995 (20%)	240	240	....	....
	$520	$400	$60	$60
1995 ending inventory	$4,520	$3,200	$660	$660

(iii) In 1995, L experiences a $200 decrement in pool Z. Thus, L must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, L determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). L then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by L in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified production method with historic absorption ratio election*—(i) *In general*. This paragraph (b)(4) generally permits producers using the simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (b)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual absorption ratio (as defined under

paragraph (b)(3)(ii) of this section) for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (b)(3)(iv) of this section. The historic absorption ratio is used in lieu of an actual absorption ratio computed under paragraph (b)(3)(ii) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio*. (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the additional section 263A costs described in §1.263A–1(d)(3) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*4*) Additional section 263A costs incurred during the test period, as defined in paragraph (b)(4)(ii)(A)(*2*) of this section, and section 471 costs incurred during the test period, as defined in paragraph (b)(4)(ii)(A)(*3*) of this section, do not include costs specifically described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(*B*) *Test period—(1) In general*. The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period*. The test period begins again with the beginning of the first taxable year after the close of a qualifying period. This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period as defined in paragraph (b)(4)(ii)(C) of this section.

(C) *Qualifying period*—(*1*) *In general*. A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or an updated test period).

(*2*) *Extension of qualifying period*. In the first taxable year following the close of each qualifying period, (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual absorption ratio under the simplified production method. If the actual absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual absorption ratios beginning with the recomputation year under the simplified production method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use*. The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified production method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (b)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified production method in determining its section 263A costs. Accordingly, in computing its actual absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (b)(4)(iii), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual absorption ratio by reason of the requirements of this paragraph (b)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election*. A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting*. A taxpayer making an election under this paragraph (b)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual absorption ratios determined under the simplified production method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) *Recordkeeping*. A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v)(A) *Transition to elect historic absorption ratio*. Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified production method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§ 1.263A–1 and 1.263A–3 had applied throughout the test period.

(B) *Transition to revoke historic absorption ratio.* Notwithstanding the requirements provided in paragraph (b)(4)(iii)(B) of this section regarding revocations of the historic absorption ratio during a qualifying period, a taxpayer will be permitted to revoke the historic absorption ratio in their first, second, or third taxable year ending on or after *November 20, 2018*, under such administrative procedures and with terms and conditions prescribed by the Commissioner.

(vi) *Example.* The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) Taxpayer M uses the FIFO method of accounting for inventories and for 1994 elects to use the historic absorption ratio with the simplified production method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (b)(4)(v) of this section, M identifies the following costs incurred during the test period:

1991:
Add'l section 263A costs—$100
Section 471 costs—$3,000
1992:
Add'l section 263A costs—$200
Section 471 costs—$4,000
1993:
Add'l section 263A costs—$300
Section 471 costs—$5,000

(ii) Therefore, M computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3{,}000 + 4{,}000 + 5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, M incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified production method using a historic absorption ratio, M determines the additional section 263A costs allocable to its ending inventory by multiplying its historic absorption ratio (5%) by the section 471 costs remaining in its ending inventory as follows:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, M adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150 = $150 + $3,000). The balance of M's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of M's cost of goods sold.

(v) M's qualifying period ends with the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which M must compute its actual absorption ratio. M determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, M must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, M's actual absorption ratio for 1999 were not between 4.5% and 5.5%, M's qualifying period would end and M would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once M's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(c) *Modified simplified production method*—(1) *Introduction.* This paragraph (c) provides a simplified method for determining the additional section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year.

(2) *Eligible property*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, the modified simplified production method, if elected for any trade or business of a

producer, must be used for all production and resale activities associated with any of the categories of property to which section 263A applies as described in paragraph (b)(2)(i) of this section.

(ii) *Election to exclude-self-constructed assets.* A taxpayer using the modified simplified production method may elect to exclude self-constructed assets from application of the modified simplified production method by following the same rules applicable to a taxpayer using the simplified production method provided in paragraph (b)(2)(ii) of this section.

(3) *Modified simplified production method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Except as otherwise provided in paragraph (c)(3)(v) of this section, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year under the modified simplified production method are computed as follows:

$$\left(\text{Pre-production absorption ratio} \times \begin{array}{c}\text{Pre-production}\\ \text{section 471 costs}\\ \text{remaining on hand}\\ \text{at year end}\end{array}\right) + \left(\text{Production absorption ratio} \times \begin{array}{c}\text{Production}\\ \text{section 471 costs}\\ \text{remaining on hand}\\ \text{at year end}\end{array}\right)$$

(B) *Effect of allocation.* The pre-production and production absorption ratios generally are multiplied by the pre-production and production section 471 costs, respectively, remaining in ending inventory or otherwise on hand at the end of each taxable year in which the modified simplified production method is applied. The sum of the resulting products is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized. See, however, paragraph (c)(3)(iv) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or §1.263A–3, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the modified simplified production method of this paragraph (c) are treated as inventory costs for all purposes of the Internal Revenue Code.

(ii) *Definitions*—(A) *Direct material costs.* For purposes of paragraph (c) of this section, direct material costs has the same meaning as described in §1.263A–1(e)(2)(i)(A). For purposes of paragraph (c) of this section, direct material costs include property produced for the taxpayer under a contract with another party that are direct material costs for the taxpayer to be used in an additional production process of the taxpayer.

(B) *Pre-production absorption ratio.* Under the modified simplified production method, the pre-production absorption ratio is determined as follows:

$$\frac{\text{Pre-production additional section 263A costs}}{\text{Pre-production section 471 costs}}$$

(*1*) *Pre-production additional section 263A costs.* Pre-production additional section 263A costs are defined as the additional section 263A costs described in §1.263A–1(d)(3) that are pre-production costs, as described in paragraph (a)(3)(ii) of this section, that a taxpayer incurs during its current taxable year, including capitalizable mixed service costs allocable to pre-production additional section 263A costs, as described in paragraph (c)(3)(iii) of this section, that a taxpayer incurs during its current taxable year:

(*i*) Plus additional section 263A costs properly allocable to property acquired for resale that a taxpayer incurs during its current taxable year; and

(*ii*) Plus additional section 263A costs properly allocable to property produced for the taxpayer under a contract with another party that is treated as property produced by the taxpayer, as described in paragraph (a)(1)(ii)(B) of this section, that a taxpayer incurs during its current taxable year.

(*2*) *Pre-production section 471 costs.* Pre-production section 471 costs are defined as the section 471 costs described in §1.263A–1(d)(2) that are direct material costs that a taxpayer incurs during its current taxable year plus the section 471 costs for property acquired for resale (*see* §1.263A–1(e)(2)(ii)) that a taxpayer incurs during its current taxable year, including property produced for the taxpayer under a contract with another party that is acquired for resale.

(C) *Pre-production section 471 costs remaining on hand at year end.* Pre-production section 471 costs remaining on hand at year end means the pre-production section 471 costs, as defined in paragraph (c)(3)(ii)(B)(*2*) of this section, that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end, excluding the section 471 costs that are direct material costs that have entered or completed production at year end (for example, direct material costs in ending work-in-process inventory and ending finished goods inventory). For LIFO inventories of a taxpayer, see paragraph (c)(3)(iv) of this section.

(D) *Production absorption ratio.* Under the modified simplified production method, the production absorption ratio is determined as follows:

$$\frac{\text{(Production additional section 263A costs + Residual pre-production additional section 263A costs)}}{\text{(Production section 471 costs + Direct materials adjustment)}}$$

(*1*) *Production additional section 263A costs.* Production additional section 263A costs are defined as the additional section 263A costs described in §1.263A–1(d)(3) that are not pre-production additional section 263A costs, as defined in paragraph (c)(3)(ii)(B)(*1*) of this section, that a taxpayer incurs during its current taxable year, including capitalizable mixed service costs not allocable to pre-production additional section 263A costs, as described in paragraph (c)(3)(iii) of this section, that a taxpayer incurs during its current taxable year. For example, production additional section 263A costs include post-production costs, other than post-production costs included in section 471 costs, as described in paragraph (a)(3)(iii) of this section.

(*2*) *Residual pre-production additional section 263A costs.* Residual pre-production additional section 263A costs are defined as the pre-production additional section 263A costs, as defined in paragraph (c)(3)(ii)(B)(*1*) of this section, that a taxpayer incurs during its current taxable year less the product of the pre-production absorption ratio, as determined in paragraph (c)(3)(ii)(B) of this section, and the pre-production section 471 costs remaining on hand at year end, as defined in paragraph (c)(3)(ii)(C) of this section.

(*3*) *Production section 471 costs.* Production section 471 costs are defined as the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs during its current taxable year less pre-production section 471 costs, as defined in paragraph (c)(3)(ii)(B)(*2*) of this section, that a taxpayer incurs during its current taxable year.

(*4*) *Direct materials adjustment.* The direct materials adjustment is defined as the section 471 costs that are direct material costs, including property produced for a taxpayer under a contract with another party that are direct material costs for the taxpayer to be used in an additional production process of the taxpayer, that had not entered production at the beginning of the current taxable year:

(*i*) Plus the section 471 costs that are direct material costs incurred during the current taxable year (that is, direct material purchases); and (*ii*) Less the section 471 costs that are direct material costs that have not entered production at the end of the current taxable year.

(E) *Production section 471 costs remaining on hand at year end.* Production section 471 costs remaining on hand at year end means the section 471 costs, as defined in §1.263A–1(d)(2), that a taxpayer incurs during its current taxable year which remain in its ending inventory or are otherwise on hand at year end, less the pre-production section 471 costs remaining on hand at year end, as described in paragraph (c)(3)(ii)(C) of this section. For LIFO inventories of a taxpayer, see paragraph (c)(3)(iv) of this section.

(F) *Costs allocated to property sold.* The terms defined in paragraph (c)(3)(ii) of this section do not include costs described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(iii) *Allocable mixed service costs*—(A) *In general.* If a taxpayer using the modified simplified production method determines its capitalizable mixed service costs using a method described in §1.263A–1(g)(4), the taxpayer must use a reasonable method to allocate the costs (for example, department or activity costs) between production and pre-production additional section 263A costs. If the taxpayer's §1.263A–1(g)(4) method allocates costs to a department or activity that is exclusively identified as production or pre-production, those costs must be allocated to production or pre-production additional section 263A costs, respectively.

(B) *Taxpayer using the simplified service cost method.* If a taxpayer using the modified simplified production method determines its capitalizable mixed service costs using the simplified service cost method described in §1.263A–1(h), the amount of capitalizable mixed service costs, as computed using the general allocation formula in §1.263A–1(h)(3)(i), allocated to and included in pre-production additional section 263A costs in the absorption ratio described in paragraph (c)(3)(ii)(B) of this section is determined based on either of the following: The proportion of direct material costs to total section 471 costs that a taxpayer incurs during its current taxable year or the proportion of pre-production labor costs to total labor costs that a taxpayer incurs during its current taxable year. The taxpayer must include the capitalizable mixed service costs that are not allocated to pre-production additional section 263A costs in production additional section 263A costs in the absorption ratio described in paragraph (c)(3)(ii)(D) of this section. A taxpayer that allocates capitalizable mixed service costs based on labor under this paragraph (c)(3)(iii)(B) must exclude mixed service labor costs from both pre-production labor costs and total labor costs.

(C) *De minimis rule.* Notwithstanding paragraphs (c)(3)(iii)(A) and (B) of this section, if 90 percent or more of a taxpayer's capitalizable mixed service costs determined under paragraph (c)(3)(iii)(A) or (B) of this section are allocated to pre-production additional section 263A costs or production additional section 263A costs, the taxpayer may elect to allocate 100 percent of its capitalizable mixed service costs to that amount. For example, if 90 percent of capitalizable mixed service costs are allocated to production additional section 263A costs based on the labor costs that are pre-production costs in total labor costs incurred in the taxpayer's trade or business during the taxable year, then 100 percent of capitalizable mixed service costs may be allocated to production additional section 263A costs. An election to allocate capitalizable mixed service costs under this paragraph (c)(3)(iii)(C) is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code.

(iv) *LIFO taxpayers electing the modified simplified production method*—(A) *In general.* Under the modified simplified production method, a taxpayer using a LIFO method must calculate a particular year's index (for example, under §1.472–8(e)) without regard to its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section

263A costs in making that determination.

(B) *LIFO increment*—(*1*) *In general*. If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in terms of section 471 costs in current-year dollars. The taxpayer then multiplies this amount by the combined absorption ratio, as defined in paragraph (c)(3)(iv)(B)(*2*) of this section. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment in terms of section 471 costs in current-year dollars for the taxable year.

(*2*) *Combined absorption ratio defined*. For purposes of paragraph (c)(3)(iv)(B)(*1*) of this section, the combined absorption ratio is the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year, as described in paragraph (c)(3)(i)(A) of this section, determined on a non-LIFO basis, divided by the pre-production and production section 471 costs remaining on hand at year end, determined on a non-LIFO basis.

(C) *LIFO decrement*. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement, excluding additional section 263A costs, to the section 471 costs in the layer of that pool.

(v) *De minimis rule for producers with total indirect costs of $200,000 or less*. Paragraph (b)(3)(iv) of this section, which provides that the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are deemed to be zero for producers with total indirect costs of $200,000 or less, applies to the modified simplified production method.

(vi) *Examples*. The provisions of this paragraph (c) are illustrated by the following examples:

(A) *Example 1—FIFO inventory method*.

(*1*) Taxpayer P uses the FIFO method of accounting for inventories valued at cost. P's beginning inventory for 2018 (all of which is sold during 2018) is $2,500,000, consisting of $500,000 of pre-production section 471 costs (including $400,000 of direct material costs and $100,000 of property acquired for resale), $1,500,000 of production section 471 costs, and $500,000 of additional section 263A costs. During 2018, P incurs $2,500,000 of pre-production section 471 costs (including $1,900,000 of direct material costs and $600,000 of property acquired for resale), $7,500,000 of production section 471 costs, $200,000 of pre-production additional section 263A costs, and $800,000 of production additional section 263A costs. P's additional section 263A costs include capitalizable mixed service costs under the simplified service cost method. P's pre-production and production section 471 costs remaining in ending inventory at the end of 2018 are $1,000,000 (including $800,000 of direct material costs and $200,000 of property acquired for resale) and $2,000,000, respectively. P computes its pre-production absorption ratio for 2018 under paragraph (c)(3)(ii)(B) of this section, as follows:

$$\frac{\text{Pre-production additional section 263A costs}}{\text{Pre-production section 471 costs}} = \frac{\$200{,}000}{\$2{,}500{,}000} = 8.00\%$$

(*2*) Under paragraph (c)(3)(ii)(D)(*2*) of this section, P's residual pre-production additional section 263A costs for 2018 are $120,000 ($200,000 of pre-production additional section 263A costs less $80,000 (the product of the 8% pre-production absorption ratio and the $1,000,000 of pre-production section 471 costs remaining on hand at year end)).

(*3*) Under paragraph (c)(3)(ii)(D)(*4*) of this section, P's direct materials adjustment for 2018 is $1,500,000 ($400,000 of direct material costs in beginning raw materials inventory, plus $1,900,000 of direct material costs incurred to acquire raw materials during the taxable year, less $800,000 direct material costs in ending raw materials inventory).

(*4*) P computes its production absorption ratio for 2018 under paragraph (c)(3)(ii)(D) of this section, as follows:

$$\frac{\text{(Production additional section 263A costs + Residual pre-production additional section 263A costs)}}{\text{(Production section 471 costs + Direct materials adjustment)}} = \frac{(\$800{,}000 + 120{,}000)}{(\$7{,}500{,}000 + 1{,}500{,}000)} = 10.22\%$$

(*5*) Under the modified simplified production method, P determines the additional section 263A costs allocable to its ending inventory under paragraph (c)(3)(i)(A) of this section by multiplying the pre-production absorption ratio by the pre-production section 471 costs remaining on hand at year end and the production absorption ratio by the production section 471 costs remaining on hand at year end, as follows:

Additional section 263A costs = (8% × $1,000,000) + (10.22% × $2,000,000) = $284,400

(*6*) P adds this $284,400 to the $3,000,000 of section 471 costs remaining on hand at year end to calculate its total ending inventory of $3,284,400. The balance of P's additional section 263A costs incurred during 2018, $715,600 ($1,000,000 less $284,400), is taken into account in 2018 as part of P's cost of goods sold.

(*7*) P's computation is summarized in the following table:

	Reference	Amount
Beginning Inventory:		
Direct material costs	a	$ 400,000
Property acquired for resale	b	100,000
Pre-production section 471 costs	c = a + b	500,000
Production section 471 costs	d	1,500,000
Additional section 263A costs	e	500,000
Total	f = c d + e	2,500,000
Incurred During 2018:		
Direct material costs	g	1,900,000
Property acquired for resale	h	600,000
Pre-production section 471 costs	i = g + h	2,500,000
Production section 471 costs	j	7,500,000
Pre-production additional section 263A costs	k	200,000
Production additional section 263A costs	l	800,000
Total	m = i + j + k + l	11,000,000
Ending Inventory:		
Direct material costs	n	800,000
Property acquired for resale	o	200,000
Pre-production section 471 costs	p = n + o	1,000,000
Production section 471 costs	q	2,000,000
Section 471 costs	r = p + q	3,000,000
Additional section 263A costs allocable to ending inventory	s = v + z	284,400
Total	t = r + s	3,284,400

	Reference	Amount
Modified Simplified Production Method:		
Pre-production additional section 263A costs	k	200,000
Pre-production section 471 costs	i	2,500,000
Pre-production absorption ratio	u = k / i	8.00%
Pre-production section 471 costs remaining on hand at year end	p	1,000,000
Pre-production additional section 263A costs allocable to ending inventory	v = u * p	80,000
Production additional section 263A costs	l	800,000
Residual pre-production additional section 263A costs	w = k − (u * p)	120,000
Production section 471 costs	j	7,500,000
Direct materials adjustment	x = a + g − n	1,500,000
Production absorption ratio	y = (l + w) / (j + x)	10.22%
Production section 471 costs remaining on hand at year end	q	2,000,000
Production additional section 263A costs allocable to ending inventory	z = y * q	204,400
Summary:		
Pre-production additional section 263A costs allocable to ending inventory	v	80,000
Production additional section 263A costs allocable to ending inventory	z	204,400
Additional section 263A costs allocable to ending inventory	s	284,400
Section 471 costs	r	3,000,000
Total Ending Inventory	t	3,284,400

(B) *Example 2—FIFO inventory method with alternative method to determine amounts of section 471 costs.*

(*1*) The facts are the same as in *Example 1* of paragraph (c)(3)(vi)(A) of this section, except that P uses the alternative method to determine amounts of section 471 costs by using its financial statement under § 1.263A–1(d)(2)(iii) rather than tax amounts under § 1.263A–1(d)(2)(i). In 2018, P's production section 471 costs exclude $40,000 of tax depreciation in excess of financial statement depreciation and include $50,000 of financial statement direct labor in excess of tax direct labor. These are P's only differences in its book and tax amounts.

(*2*) Under § 1.263A–1(d)(2)(iii)(B), the positive $40,000 depreciation adjustment and the negative $50,000 direct labor adjustment must be included in additional section 263A costs. Accordingly, P's production additional section 263A costs are $790,000 ($800,000 plus $40,000 less $50,000).

(*3*) P computes its production absorption ratio for 2018 under paragraph (c)(3)(ii)(D) of this section, as follows:

$$\frac{\text{(Production additional section 263A costs + Residual pre-production additional section 263A costs)}}{\text{(Production section 471 costs + Direct materials adjustment)}} = \frac{(\$790{,}000 + 120{,}000)}{(\$7{,}500{,}000 + 1{,}500{,}000)} = 10.11\%$$

(*4*) Under the modified simplified production method, P determines the additional section 263A costs allocable to its ending inventory under paragraph (c)(3)(i)(A) of this section by multiplying the pre-production absorption ratio by the pre-production section 471 costs remaining on hand at year end and the production absorption ratio by the production section 471 costs remaining on hand at year end, as follows:

Additional section 263A costs = (8.00% × $1,000,000) + (10.11% × $2,000,000) = $282,200

(*5*) P adds this $282,200 to the $3,000,000 of section 471 costs remaining on hand at year end to calculate its total ending inventory of $3,282,200. The balance of P's additional section 263A costs incurred during 2018, $717,800 ($1,000,000 less $282,200), is taken into account in 2018 as part of P's cost of goods sold.

(C) *Example 3—LIFO inventory method.*

(*1*) The facts are the same as in *Example 1* of paragraph (c)(3)(vi)(A) of this section, except that P uses a dollar-value LIFO inventory method rather than the FIFO method. P's 2018 LIFO increment is $1,500,000.

(*2*) Under paragraph (c)(3)(iv)(B)(*1*) of this section, to determine the additional section 263A costs allocable to its ending inventory, P multiplies the combined absorption ratio by the $1,500,000 of LIFO increment. Under paragraph (c)(3)(iv)(B)(*2*) of this section, the combined absorption ratio is 9.48% ($284,400 additional section 263A costs allocable to ending inventory, determined on a non-LIFO basis, divided by $3,000,000 of section 471 costs on hand at year end, determined on a non-LIFO basis). Thus, P's additional section 263A costs allocable to its ending inventory are $142,200 ($1,500,000 multiplied by 9.48%). This $142,200 is added to the $1,500,000 to determine a total 2018 LIFO increment of $1,642,200. The balance of P's additional section 263A costs incurred during 2018, $857,800 ($1,000,000 less $142,200), is taken into account in 2018 as part of P's cost of goods sold.

(*3*) In 2019, P sells one-half of the inventory in its 2018 increment. P must include in its cost of goods sold for 2019 the amount of additional section 263A costs relating to this inventory, $71,100 (one-half of the $142,200 additional section 263A costs capitalized in 2018 ending inventory).

(D) *Example 4—Direct materials-based allocation of mixed service costs.*

(*1*) Taxpayer R computes its capitalizable mixed service costs using the simplified service cost method described in §1.263A–1(h). During 2018, R incurs $200,000 of capitalizable mixed service costs, computed using the general allocation formula in §1.263A–1(h). During 2018, R also incurs $8,000,000 of total section 471 costs, including $2,000,000 of direct material costs.

(*2*) Under paragraph (c)(3)(iii)(B) of this section, R determines its capitalizable mixed service costs allocable to pre-production additional section 263A costs based on the proportion of direct material costs in total section 471 costs. R's direct material costs are 25% of total section 471 costs ($2,000,000 of direct material costs incurred during the year divided by $8,000,000 of total section 471 costs incurred during the year). Thus, R allocates $50,000 (25% × $200,000) of mixed service costs to pre-production additional section 263A costs. R includes the remaining $150,000 ($200,000 less $50,000) of capitalizable mixed service costs as production additional section 263A costs.

(E) *Example 5—Labor-based allocation of mixed service costs.*

(*1*) Taxpayer S computes its capitalizable mixed service costs using the simplified service cost method described in §1.263A–1(h). During 2018, S incurs $200,000 of capitalizable mixed service costs, computed using the general allocation formula in §1.263A–1(h). During 2018, S also incurs $10,000,000 of total labor costs (excluding any labor costs included in mixed service costs), including $1,000,000 of labor costs that are pre-production costs as described in paragraph (a)(3)(ii) of this section (excluding any labor costs included in mixed service costs).

(*2*) Under paragraph (c)(3)(iii)(B) of this section, S determines its capitalizable mixed service costs allocable to pre-production additional section 263A costs based on the proportion of labor costs that are pre-production costs in labor costs. S's pre-production labor costs are 10% of labor costs ($1,000,000 of labor costs incurred during the year that are pre-production costs (excluding any labor costs included in mixed service costs), divided by $10,000,000 of total labor costs incurred during the year (excluding any labor costs included in mixed service costs). Thus, S allocates $20,000 (10% × $200,000) of mixed service costs to pre-production additional section 263A costs. S includes the remaining $180,000 ($200,000 less $20,000) of capitalizable mixed service costs as production additional section 263A costs.

(F) *Example 6—De minimis rule for allocation of mixed service costs.* The facts are the same as in *Example 5* in paragraph (c)(3)(vi)(E) of this section, except that S uses the de minimis rule for mixed service costs in paragraph (c)(3)(iii)(C) of this section. Because 90% or more of S's capitalizable mixed service costs are allocated to production additional section 263A costs, under the de minimis rule, S allocates all $200,000 of capitalizable mixed service costs to production additional section 263A costs. None of the capitalizable mixed service costs are allocated to pre-production additional section 263A costs.

(4) *Modified simplified production method with historic absorption ratio election*—(i) *In general.* This paragraph (c)(4) generally permits taxpayers using the modified simplified production method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. A taxpayer may only make a historic absorption ratio election under this paragraph (c)(4) if it has used the modified simplified production method for three or more consecutive taxable years immediately prior to the year of election and has capitalized additional section 263A costs using an actual pre-production absorption ratio, as defined in paragraph (c)(3)(ii)(B) of this section, and an actual production absorption ratio, as defined in paragraph (c)(3)(ii)(D) of this section, or an actual combined absorption ratio, as defined in paragraph (c)(3)(iv)(B)(*2*) of this section, for its three most recent consecutive taxable years. This method is not available to a taxpayer that is deemed to have zero additional section 263A costs under paragraph (c)(3)(v) of this section. The historic absorption ratio is used in lieu of the actual absorption ratios computed under paragraph (c)(3)(ii) of this section or the actual combined absorption ratio computed under paragraph (c)(3)(iv) and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for each taxable year within the qualifying period described in paragraph (b)(4)(ii)(C) of this section. Except as otherwise provided in this paragraph (c)(4), paragraph (b)(4) of this section applies to the historic absorption ratio election under the modified simplified production method.

(ii) *Operating rules and definitions*—(A) *Pre-production historic absorption ratio.* The pre-production historic absorption ratio is computed as follows:

$$\frac{\text{Pre-production additional section 263A costs incurred during the test period}}{\text{Pre-production section 471 costs incurred during the test period}}$$

(*1*) Pre-production additional section 263A costs incurred during the test period are defined as the pre-production additional section 263A costs described in paragraph (c)(3)(ii)(B)(*1*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*2*) Pre-production section 471 costs incurred during the test period are defined as the pre-production section 471 costs described in paragraph (c)(3)(ii)(B)(*2*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(B) *Production historic absorption ratio.* The production historic absorption ratio is computed as follows:

$$\frac{\left(\text{Production additional section 263A costs incurred during the test period} + \text{Residual pre-production additional section 263A costs incurred during the test period}\right)}{\left(\text{Production section 471 costs incurred during the test period} + \text{Direct materials adjustments made during the test period}\right)}$$

(*1*) Production additional section 263A costs incurred during the test period are defined as the production additional section 263A costs described in paragraph (c)(3)(ii)(D)(*1*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*2*) Residual pre-production additional section 263A costs incurred during the test period are defined as the residual pre-production additional section 263A costs described in paragraph (c)(3)(ii)(D)(*2*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*3*) Production section 471 costs incurred during the test period are defined as the production section 471 costs described in paragraph (c)(3)(ii)(D)(*3*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(*4*) Direct materials adjustments made during the test period are defined as the direct materials adjustments described in paragraph (c)(3)(ii)(D)(*4*) of this section that the taxpayer incurs during the test period described in paragraph (b)(4)(ii)(B) of this section.

(iii) *LIFO taxpayers making the historic absorption ratio election*—(A) *In general.* Instead of the pre-production and production historic absorption ratios defined in paragraph (c)(4)(ii) of this section, a LIFO taxpayer making the historic absorption ratio election under the modified simplified production method calculates a combined historic absorption ratio based on costs the taxpayer capitalizes during its test period.

(B) *Combined historic absorption ratio.* The combined historic absorption ratio is computed as follows:

$$\frac{\text{Total allocable additional section 263A costs incurred during the test period}}{\text{Total section 471 costs remaining on hand at each year end of the test period}}$$

(*1*) *Total allocable additional section 263A costs incurred during the test period.* Total allocable additional section 263A costs incurred during the test period are the sum of the total additional section 263A costs allocable to eligible property on hand at year end as described in paragraph (c)(3)(i)(A) of this section, determined on a non-LIFO basis, for all taxable years in the test period.

(*2*) *Total section 471 costs remaining on hand at each year end of the test period.* Total section 471 costs remaining on hand at each year end of the test period are the sum of the total pre-production section 471 costs remaining on hand at year end as described in paragraph (c)(3)(ii)(C) of this section and the total production section 471 costs remaining on hand at year end as described in paragraph (c)(3)(ii)(E) of this section, determined on a non-LIFO basis, for all taxable years in the test period.

(iv) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period (for example, the sixth taxable year following the test period), a taxpayer must compute the actual absorption ratios under paragraph (c)(3) of this section (pre-production and production absorption ratios or, for LIFO taxpayers, the combined absorption ratio). If the actual combined absorption ratio or both the actual pre-production and production absorption ratios, as applicable, computed for this taxable year (the recomputation year) is within one-half of one percentage point, plus or minus, of the corresponding historic absorption ratio or ratios used in determining capitalizable costs for the qualifying period (the previous five taxable years), the qualifying period is extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio or ratios throughout the extended qualifying period. If, however, the actual combined historic absorption ratio or either the actual pre-production absorption ratio or production absorption ratio, as applicable, is not within one-half of one percentage point, plus or minus, of the corresponding historic absorption ratio, the taxpayer must use the actual combined absorption ratio or ratios beginning with the recomputation year and throughout the updated test period. The taxpayer must resume using the historic absorption ratio or ratios based on the updated test period in the third taxable year following the recomputation year.

(v) *Examples.* The provisions of this paragraph (c)(4) are illustrated by the following examples:

(A) *Example 1—HAR and FIFO inventory method.*

(*1*) Taxpayer S uses the FIFO method of accounting for inventories valued at cost and for 2021 elects to use the historic absorption ratio with the modified simplified production method. S identifies the following costs incurred during the test period:

	2018	2019	2020
Pre-production additional section 263A costs	$100	$200	$300
Production additional section 263A costs	200	350	450
Pre-production section 471 costs	2,000	2,500	3,000
Production section 471 costs	2,500	3,500	4,000
Residual pre-production additional section 263A costs	60	136	220
Direct materials adjustments	2,700	3,200	3,700

(*2*) Under paragraph (c)(4)(ii)(A) of this section, S computes the pre-production historic absorption ratio as follows:

$$\frac{\text{Pre-production additional section 263A costs incurred during the test period}}{\text{Pre-production section 471 costs incurred during the test period}} = \frac{\$100 + 200 + 300}{\$2{,}000 + 2{,}500 + 3{,}000} = \frac{\$600}{\$7{,}500} = 8.00\%$$

(*3*) Under paragraph (c)(4)(ii)(B) of this section, S computes the production historic absorption ratio as follows:

$$\frac{\left(\text{Production additional section 263A costs incurred during the test period} + \text{Residual pre-production additional section 263A costs incurred during the test period}\right)}{\left(\text{Production section 471 costs incurred during the test period} + \text{Direct materials adjustments made during the test period}\right)}$$

$$= \frac{((\$200+350+450)+(60+136+220))}{((\$2{,}500+3{,}500+4{,}000)+(2{,}700+3{,}200+3{,}700))} = \frac{\$1{,}416}{\$19{,}600} = 7.22\%$$

(*4*) In 2021, S incurs $10,000 of section 471 costs of which $1,000 pre-production section 471 costs and $2,000 production 471 costs remain in ending inventory. Under the modified simplified production method using a historic absorption ratio, S determines the pre-production additional section 263A costs allocable to its ending inventory by multiplying its pre-production historic absorption ratio (8.00%) by the pre-production section 471 costs remaining on hand at year end ($1,000). Thus, S allocates $80 of pre-production additional section 263A costs to its ending inventory (8.00% × $1,000). S determines the production additional section 263A costs allocable to its ending inventory by multiplying its production historic absorption ratio (7.22%) by the production section 471 costs remaining on hand at year end ($2,000). Thus, S allocates $144 of production additional section 263A costs to its ending inventory (7.22% × $2,000).

(*5*) Under paragraph (c)(4)(i) of this section, S's total additional section 263A costs allocable to ending inventory in 2021 are $224, which is the sum of the allocable pre-production additional section 263A costs ($80) and the allocable production additional section

263A costs ($144). S's ending inventory in 2021 is $3,224, which is the sum of S's additional section 263A costs allocable to ending inventory and S's section 471 costs remaining in ending inventory ($224 + $3,000). The balance of S's additional section 263A costs incurred during 2021 is taken into account in 2021 as part of S's cost of goods sold.

(B) *Example 2—HAR and LIFO inventory method.* (*1*)(*i*) The facts are the same as in *Example 1* in paragraph (c)(4)(v)(A) of this section, except that S uses a dollar-value LIFO inventory method rather than the FIFO method. S calculates additional section 263A costs incurred during the taxable year and allocable to ending inventory under paragraph (c)(4)(iii) of this section and identifies the following costs incurred during the test period:

	2018	2019	2020
Additional section 263A costs incurred during the taxable year allocable to ending inventory	$90	$137	$167
Section 471 costs incurred during the taxable year that remain in ending inventory	1,000	1,400	2,100

(*ii*) In 2021, the LIFO value of S's increment is $1,500.

(*2*) Under paragraph (c)(4)(iii) of this section, S computes a combined historic absorption ratio as follows:

$$\frac{\text{Total allocable additional section 263A costs incurred during the test period}}{\text{Total section 471 costs remaining on hand at each year end of the test period}} = \frac{\$90 + 137 + 167}{\$1{,}000 + 1{,}400 + 2{,}100} = \frac{\$394}{\$4{,}500} = 8.76\%$$

(*3*) S's additional section 263A costs allocable to its 2021 LIFO increment are $131 ($1,500 beginning LIFO increment × 8.76% combined historic absorption ratio). S adds the $131 to the $1,500 LIFO increment to determine a total 2021 LIFO increment of $1,631.

(d) *Additional simplified methods for producers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(e) *Cross reference.* See § 1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

(f) *Change in method of accounting*—(1) *In general.* A change in a taxpayer's treatment of additional section 263A costs to comply with paragraph (b)(2)(i)(D) of this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations under those sections apply. See § 1.263A–7. For a taxpayer's first taxable year ending on or after August 2, 2005, the taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (4) of this section, issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in accounting method (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 CB 327), as modified and clarified by Announcement 2002–17 (2002–1 CB 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), and amplified, clarified, and modified by Rev. Proc. 2002–54 (2002–2 CB 432), and § 601.601(d)(2)(ii)(*b*) of this chapter). For purposes of Form 3115, ''Application for Change in Accounting Method,'' the designated number for the automatic accounting method change authorized by this paragraph (e) is ''95.'' If Form

3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form. Alternatively, notwithstanding the provisions of any administrative procedures that preclude a taxpayer from requesting the advance consent of the Commissioner to change a method of accounting that is required to be made pursuant to a published automatic change procedure, for its first taxable year ending on or after August 2, 2005, a taxpayer may request the advance consent of the Commissioner to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section, provided the taxpayer follows the administrative procedures, as modified by paragraphs (e)(2) through (5) of this section, for obtaining the advance consent of the Commissioner (for further guidance, for example, see Rev. Proc. 97–27 (1997–1 CB 680), as modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696), as amplified and clarified by Rev. Proc. 2002–54 (2002–2 CB 432), and §601.601(d)(2)(ii)(*b*) of this chapter). For the taxpayer's second and subsequent taxable years ending on or after August 2, 2005, requests to secure the consent of the Commissioner must be made under the administrative procedures, as modified by paragraphs (e)(3) and (4) of this section, for obtaining the Commissioner's advance consent to a change in accounting method.

(2) *Scope limitations.* Any limitations on obtaining the automatic consent or advance consent of the Commissioner do not apply to a taxpayer seeking to change its method of accounting to comply with paragraph (b)(2)(i)(D) of this section for its first taxable year ending on or after August 2, 2005.

(3) *Audit protection.* A taxpayer that changes its method of accounting in accordance with this paragraph (e) to comply with paragraph (b)(2)(i)(D) of this section does not receive audit protection if its method of accounting for additional section 263A costs is an issue under consideration at the time the application is filed with the national office.

(4) *Section 481(a) adjustment.* A change in method of accounting to conform to paragraph (b)(2)(i)(D) of this section requires a section 481(a) adjustment. The section 481(a) adjustment period is two taxable years for a net positive adjustment for an accounting method change that is made to conform to paragraph (b)(2)(i)(D) of this section.

(5) *Time for requesting change.* Notwithstanding the provisions of §1.446–1(e)(3)(i) and any contrary administrative procedure, a taxpayer may submit a request for advance consent to change its method of accounting to comply with paragraph (b)(2)(i)D) of this section for its first taxable year ending on or after August 2, 2005, on or before the date that is 30 days after the end of the taxable year for which the change is requested.

(g) *Applicability dates.* (1) Paragraphs (b)(2)(i)(D), (e), and (f) of this section apply for taxable years ending on or after August 2, 2005.

(2) Paragraphs (b)(3)(ii)(C) and (b)(4)(ii)(A)(*4*) of this section apply for taxable years ending on or after January 13, 2014.

(3) Paragraph (c) of this section applies for taxable years beginning on or after November 20, 2018. For any taxable year that both begins before November 20, 2018 and ends after November 20, 2018, the IRS will not challenge return positions consistent with all of paragraphs (c) of this section.

(4) The rules set forth in the last sentence of the introductory text of paragraph (a) of this section and in paragraph (a)(1)(ii)(C) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(4), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

[T.D. 8482, 58 FR 42219, Aug. 9, 1993, as amended by 59 FR 3318, 3319, Jan. 21, 1994; T.D. 8584, 59 FR 67197, Dec. 29, 1994; T.D. 9217, 70 FR 44469, Aug. 3, 2005; T.D. 9318, 72 FR 14677, Mar. 29, 2007; T.D. 9652, 79 FR 2097, Jan. 13, 2014; T.D. 9843, 83 FR 58491, Nov. 20, 2018; T.D. 9942, 86 FR 266, Jan. 5, 2021]

§ 1.263A–3 Rules relating to property acquired for resale.

(a) *Capitalization rules for property acquired for resale*—(1) *In general.* Section 263A applies to real property and personal property described in section 1221(1) acquired for resale by a retailer, wholesaler, or other taxpayer (reseller). However, for taxable years beginning after December 31, 2017, a small business taxpayer, as defined in § 1.263A–1(j), is not required to apply section 263A in that taxable year.For this purpose, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade of the taxpayer or other property which is includible in the taxpayer's inventory if on hand at the close of the taxable year, and property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. See, however, § 1.263A–1(b)(11) for an exception for certain de minimis property provided to customers incident to the provision of services.

(2) *Resellers with production activities*—(i) *In general.* Generally, a taxpayer must capitalize all direct costs and certain indirect costs associated with real property and tangible personal property it produces. See § 1.263A–2(a). Thus, except as provided in paragraphs (a)(2)(ii) and (3) of this section, a reseller, including a small reseller, that also produces property must capitalize the additional section 263A costs associated with any property it produces.

(ii) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see § 1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and § 1.448–2(c).

(iii) *De minimis production activities.* See paragraph (a)(5) of this section for rules relating to an exception for resellers with *de minimis* production activities.

(3) *Resellers with property produced under contract.* Generally, property produced for a taxpayer under a contract (within the meaning of § 1.263A–2(a)(1)(ii)(B)(*2*)) is treated as property produced by the taxpayer. See § 1.263A–2(a)(1)(ii)(B). However, a small business taxpayer is not required to capitalize additional section 263A costs to personal property produced for it under contract with an unrelated person if the contract is entered into incident to the resale activities of the small business taxpayer and the property is sold to its customers. For purposes of this paragraph, persons are related if they are described in section 267(b) or 707(b).

(4) *Use of the simplified resale method*—(i) *In general.* Except as provided in paragraphs (a)(4)(ii) and (iii) of this section, a taxpayer may elect the simplified production method, as described in § 1.263A–2(b), or the modified simplified production method, as described in § 1.263A–2(c), but may not elect the simplified resale method, as described in paragraph (d) of this section, if the taxpayer is engaged in both production and resale activities with respect to the items of eligible property listed in § 1.263A–2(b)(2).

(ii) *Resellers with de minimis production activities.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method if its production activities with respect to the items of eligible property listed in § 1.263A–2(b)(2) are de minimis (within the meaning of paragraph (a)(5) of this section) and incident to its resale of personal property described in section 1221(1).

(iii) *Resellers with property produced under a contract.* A reseller otherwise permitted to use the simplified resale method in paragraph (d) of this section may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. For purposes of this paragraph (a)(4)(iii), persons are related if they are described in section 267(b) or 707(b).

(iv) *Application of simplified resale method.* A taxpayer that uses the simplified resale method and has de minimis production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method.

(5) *De minimis production activities*—(i) *In general.* In determining whether a taxpayer's production activities are *de minimis,* all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed *de minimis* if—

(A) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(B) The labor costs allocable to the trade or business's production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(ii) *Definition of gross receipts to determine de minimis production activities.* Gross receipts has the same definition as for purposes of the gross receipts test under §1.448–2(c), except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

(iii) *Example: Reseller with de minimis production activities.* Taxpayer N is in the retail grocery business. In 2019, N's average annual gross receipts for the three previous taxable years are greater than the gross receipts test of section 448(c). Thus, N is not exempt from the requirement to capitalize costs under section 263A. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N produces no other goods in its retail grocery business. N's gross receipts from its bakeries are 5 percent of the entire grocery business. N's labor costs from its bakeries are 3 percent of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10 percent, N's production activities are *de minimis.* Further, because N's production activities are incident to its resale activities, N may use the simplified resale method, as provided in paragraph (a)(4)(ii) of this section.

(b) [Reserved]

(c) *Purchasing, handling, and storage costs*—(1) *In general.* Generally, §1.263A–1(e) describes the types of costs that must be capitalized by taxpayers. Resellers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A–1(e)(3), which are properly allocable to property acquired for resale. The indirect costs most often incurred by resellers are purchasing, handling, and storage costs. This paragraph (c) provides additional guidance regarding each of these categories of costs. As provided in §1.263A–1(e), this paragraph (c) also applies to producers incurring purchasing, handling, and storage costs.

(2) *Costs attributable to purchasing, handling, and storage.* The costs attributable to purchasing, handling, and storage activities generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits); occupancy expenses including rent, depreciation, insurance, security, taxes, utilities and maintenance; materials and supplies; rent, maintenance, depreciation, and insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities.

(3) *Purchasing costs*—(i) *In general.* Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs (e.g., of buyers, assistant buyers, and clerical workers), relating to—

(A) The selection of merchandise;

(B) The maintenance of stock assortment and volume;

(C) The placement of purchase orders;

(D) The establishment and maintenance of vendor contacts; and

(E) The comparison and testing of merchandise.

(ii) *Determination of whether personnel are engaged in purchasing activities.* The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. Thus, for example, although an employee's job function may be described in such a way as to indicate activities outside the area of purchasing (e.g., a marketing representative), such activities must be analyzed on the basis of the activities performed by that employee. If a person performs both purchasing and non-purchasing activities, the taxpayer must reasonably allocate the person's labor costs between these activities. For example, a reasonable allocation is one based on the amount of time the person spends on each activity.

(A) *⅓–⅔ rule for allocating labor costs.* A taxpayer may elect the ⅓–⅔ rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the taxpayer must allocate the labor costs of all such persons using the ⅓–⅔ rule. Under this rule—

(*1*) If less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing;

(*2*) If more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and

(*3*) In all other cases, the taxpayer must reasonably allocate labor costs between purchasing and non-purchasing activities.

(B) *Example.* The application of paragraph (c)(3)(ii)(A) of this section may be illustrated by the following example:

Example. Taxpayer O is a reseller that employs three persons, A, B, and C, who perform both purchasing and non- purchasing activities. These persons spend the following time performing purchasing activities: A–25 %; B–70 %; and C–50 %. Under the ⅓–⅔ rule, Taxpayer O treats none of A's labor costs as purchasing costs, all of B's labor costs as purchasing costs, and Taxpayer O allocates 50 % of C's labor costs as purchasing costs.

(4) *Handling costs*—(i) *In general.* Handling costs include costs attributable to processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale, provided the activities do not come within the meaning of the term produce as defined in §1.263A–2(a)(1). Handling costs are generally required to be capitalized under section 263A. Under this paragraph (c)(4)(i), however, handling costs incurred at a retail sales facility (as defined in paragraph (c)(5)(ii)(B) of this section) with respect to property sold to retail customers at the facility are not required to be capitalized. Thus, for example, handling costs incurred at a retail sales facility to unload, unpack, mark, and tag goods sold to retail customers at the facility are not required to be capitalized. In addition, handling costs incurred at a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) with respect to property sold to customers from the facility are not required to be capitalized to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the ratio in paragraph (c)(5)(iii)(B) of this section.

(ii) *Processing costs.* Processing costs are the costs a reseller incurs in making minor changes or alterations to the nature or form of a product acquired for resale. Minor changes to a product include, for example, monogramming a sweater, altering a pair of pants, and other similar activities.

(iii) *Assembling costs.* Generally, assembling costs are costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale).

(iv) *Repackaging costs.* Repackaging costs are the costs a taxpayer incurs to package property for sale to its customers.

(v) *Transportation costs.* Generally, transportation costs are the costs a taxpayer incurs moving or shipping property acquired for resale. These costs include the cost of dispatching trucks; loading and unloading shipments; and sorting, tagging, and marking property. Transportation costs may consist of depreciation on trucks and equipment and the costs of fuel, insurance, labor, and similar costs. Generally, transportation costs required to be capitalized include costs incurred in transporting property—

(A) From the vendor to the taxpayer;

(B) From one of the taxpayer's storage facilities to another of its storage facilities;

(C) From the taxpayer's storage facility to its retail sales facility;

(D) From the taxpayer's retail sales facility to its storage facility; and

(E) From one of the taxpayer's retail sales facilities to another of its retail sales facilities.

(vi) *Costs not required to be capitalized as handling costs*—(A) *Distribution costs*—(*1*) *In general*. Distribution costs are not required to be capitalized. Distribution costs are any transportation costs incurred outside a storage facility in delivering goods to a customer. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility.

(*2*) *Costs incurred in transporting goods to a related person*. Distribution costs do not include costs incurred by a taxpayer in delivering goods to a related person. Thus, for example, when a taxpayer sells goods to a related person, the costs of transporting the goods are included in determining the basis of the goods that are sold, and hence in determining the resulting gain or loss from the sale, for all purposes of the Internal Revenue Code and the regulations thereunder. See, e.g., sections 267, 707, and 1502. For purposes of this provision, persons are related if they are described in section 267(b) or section 707(b).

(B) *Delivery of custom-ordered items*. Generally, costs incurred in transporting goods from a taxpayer's storage facility to its retail sales facility must be capitalized. However, costs incurred outside a storage facility in delivering custom-ordered items to a retail sales facility are not required to be capitalized. For this purpose, any costs incurred on a loading dock are treated as incurred outside a storage facility. Delivery of custom-ordered items occurs when a taxpayer can demonstrate that a delivery to the taxpayer's retail sales facility is made to fill an identifiable order of a particular customer (placed by the customer before the delivery of the goods occurs) for the particular goods in question. Factors that may demonstrate the existence of a specific, identifiable delivery include the following—

(*1*) The customer has paid for the item in advance of the delivery;

(*2*) The customer has submitted a written order for the item;

(*3*) The item is not normally available at the retail sales facility for onsite customer purchases; and

(*4*) The item will be returned to the storage facility (and not held for sale at the retail sales facility) if the customer cancels an order.

(C) *Pick and pack costs*—(*1*) *In general*. Generally, handling costs incurred inside a storage or warehousing facility must be capitalized. However, costs attributable to pick and pack activities inside a storage or warehousing facility are not required to be capitalized. Pick and pack activities are activities undertaken in preparation for imminent shipment to a particular customer after the customer has ordered the specific goods in question. Examples of pick and pack activities include:

(*i*) Moving specific goods from a storage location in preparation for shipment to the customer;

(*ii*) Packing or repacking those goods for shipment to the customer; and

(*iii*) Staging those goods for shipment to the customer.

(*2*) *Activities that are not pick and pack activities*. Pick and pack activities do not include:

(*i*) Unloading goods that are received for storage;

(*ii*) Checking the quantity and quality of goods received;

(*iii*) Comparing the quantity of goods received to the amounts ordered and preparing the receiving documents;

(*iv*) Moving the goods to their storage location, e.g., bins, racks, containers, etc.; and

(*v*) Storing the goods.

(*3*) *Costs not attributable to pick and pack activities*. Occupancy costs, such as rent, depreciation, insurance, security, taxes, utilities, and maintenance costs properly allocable to the storage or warehousing facility, are not costs attributable to pick and pack activities.

(5) *Storage costs*—(i) *In general*. Generally, storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility (an off-site storage facility). However, storage costs attributable to the operation of an on-site storage facility (as defined in paragraph (c)(5)(ii)(A) of this section) are not required to be capitalized under section 263A. Storage costs attributable to a dual-function storage facility (as defined in paragraph (c)(5)(ii)(G) of this section) must be

capitalized to the extent that the facility's costs are allocable to off-site storage.

(ii) *Definitions*—(A) *On-site storage facility*. An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility.

(B) *Retail sales facility*. (*1*) A retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site—

(*i*) Which are customarily associated with and are an integral part of the operations of that retail site;

(*ii*) Which are generally open each business day exclusively to retail customers;

(*iii*) On or in which retail customers normally and routinely shop to select specific items of merchandise; and

(*iv*) Which are adjacent to or in immediate proximity to other portions of the specific retail site.

(*2*) Thus, for example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

(C) *An integral part of a retail sales facility*. A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility.

(D) *On-site sales*. On-site sales are defined as sales made to retail customers physically present at a facility. For example, mail order and catalog sales are made to customers not physically present at the facility, and thus, are not on-site sales.

(E) *Retail customer*—(*1*) *In general*. A retail customer is defined as the final purchaser of the merchandise. A retail customer does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers.

(*2*) *Certain non-retail customers treated as retail customers*. For purposes of this section, a non-retail customer is treated as a retail customer with respect to a particular facility if the following requirements are satisfied—

(*i*) The non-retail customer purchases goods under the same terms and conditions as are available to retail customers (e.g., no special discounts);

(*ii*) The non-retail customer purchases goods in the same manner as a retail customer (e.g., the non-retail customer may not place orders in advance and must come to the facility to examine and select goods);

(*iii*) Retail customers shop at the facility on a routine basis (i.e., on most business days), and no special days or hours are reserved for non-retail customers; and

(*iv*) More than 50 percent of the gross sales of the facility are made to retail customers.

(F) *Off-site storage facility*. An off-site storage facility is defined as a storage facility that is not an on-site storage facility.

(G) *Dual-function storage facility*. A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. For example, a dual-function storage facility would include a regional warehouse that serves the taxpayer's separate retail sales outlets and also contains a sales outlet therein. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to—

(*1*) Retail customers in sales that are not on-site sales; or

(*2*) Other customers.

(iii) *Treatment of storage costs incurred at a dual-function storage facility*—(A) *In general*. Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function. To the extent that the dual-function storage facility's storage costs are allocable to the off-site storage function, they must be capitalized. To the extent that the dual-function storage facility's storage costs are allocable to the on-site storage function, they are not required to be capitalized.

(B) *Dual-function storage facility allocation ratio*—(*1*) *In general.* Storage costs associated with a dual-function storage facility must be allocated between the off-site storage function and the on-site storage function using the ratio of—

(*i*) Gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person and purchasing merchandise stored therein); to

(*ii*) Total gross sales of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

(*2*) *Illustration of ratio allocation.* For example, if a dual-function storage facility's on-site sales are 40 percent of the total gross sales of the facility, then 40 percent of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized under section 263A.

(*3*) *Appropriate adjustments for other uses of a dual-function storage facility.* Prior to computing the allocation ratio in paragraph (c)(5)(iii)(B) of this section, a taxpayer must apply the principles of paragraph (c)(5)(iv) of this section in determining the portion of the facility that is a dual-function storage facility (and the costs attributable to such portion).

(C) *De minimis 90–10 rule for dual-function storage facilities.* If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility.

(iv) *Costs not attributable to an off-site storage facility.* To the extent that costs incurred at an off-site storage facility are not properly allocable to the taxpayer's storage function, the costs are not accounted for as off-site storage costs. For example, if a taxpayer has an office attached to its off-site storage facility where work unrelated to the storage function is performed, such as a sales office, costs associated with this office are not off-site storage costs. However, if a taxpayer uses a portion of an off-site storage facility in a manner related to the storage function, for example, to store equipment or supplies that are not offered for sale to customers, costs associated with this portion of the facility are off-site storage costs.

(v) *Examples.* The provisions of this paragraph (c)(5) are illustrated by the following examples:

Example 1. Catalog or mail order center. Taxpayer P operates a mail order catalog business. As part of its business, P stores merchandise for shipment to customers who purchase the merchandise through orders placed by telephone or mail. P's storage facility is not an on-site storage facility because no onsite sales are made at the facility.

Example 2. Pooled-stock facility. Taxpayer Q maintains a pooled-stock facility, which functions as a back-up regional storage facility for Q's retail sales outlets in the nearby area. Q's pooled stock facility is an off-site storage facility because it is neither physically attached to nor an integral part of a retail sales facility.

Example 3. Wholesale warehouse. Taxpayer R operates a wholesale warehouse where wholesale sales are made to customers physically present at the facility. R's customers resell the goods they purchase from R to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to R's wholesale warehouse must be capitalized.

(d) *Simplified resale method*—(1) *Introduction.* This paragraph (d) provides a simplified method for determining the additional section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year.

(2) *Eligible property.* Generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. However, certain resellers with property produced as a result of de minimis production activities or property produced under contract may elect the simplified resale method, as described in paragraph (a)(4) of this section. Eligible property for purposes of the simplified resale method, therefore, includes any real or personal property described in section 1221(1) that is acquired for resale and any eligible property (within the meaning of §1.263A–

2(b)(2)) that is described in paragraph (a)(4) of this section.

(3) *Simplified resale method without historic absorption ratio election*—(i) *General allocation formula*—(A) *In general.* Under the simplified resale method, the additional section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows:

$$\text{Combined absorption ratio} \times \text{section 471 costs remaining on hand at year end}$$

(B) *Effect of allocation.* The resulting product under the general allocation formula is the additional section 263A costs that are added to the taxpayer's ending section 471 costs to determine the section 263A costs that are capitalized.

(C) *Definitions*—(*1*) *Combined absorption ratio.* The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio as defined in paragraph (d)(3)(i)(D) of this section and the purchasing costs absorption ratio as defined in paragraph (d)(3)(i)(E) of this section.

(*2*) *Section 471 costs remaining on hand at year end.* Section 471 costs remaining on hand at year end mean the section 471 costs, as defined in §1.263A–1(d)(2), that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end. For LIFO inventories of a taxpayer, the section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of section 471 costs. See paragraph (d)(3)(ii) of this section for special rules applicable to LIFO taxpayers. Except as otherwise provided in this section or in §1.263A–1 or 1.263A–2, additional section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.

(*3*) *Costs allocable to property sold.* Section 471 costs remaining on hand at year end, as defined in paragraph (d)(3)(i)(C)(*2*) of this section, do not include costs that are specifically described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(D) *Storage and handling costs absorption ratio.* (*1*) Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

(*2*) Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and other eligible property. See paragraph (c) of this section, which discusses storage and handling costs. Storage and handling costs must include the amount of allocable mixed service costs as described in paragraph (d)(3)(i)(F) of this section. Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the section 471 costs of any property acquired for resale or other eligible property held by the taxpayer as of the beginning of the taxable year. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. In computing the denominator of the storage and handling costs absorption ratio, a taxpayer using a dollar-value LIFO method of accounting, must state beginning inventory amounts using the

LIFO carrying value of the inventory and not current-year dollars.

(*3*) Current year's storage and handling costs, beginning inventory, and current year's purchases, as defined in paragraph (d)(3)(i)(D)(*2*) of this section, do not include costs that are specifically described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(E) *Purchasing costs absorption ratio.* (*1*) Under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

$$\frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

(*2*) Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the taxpayer's property acquired for resale and eligible property. See paragraph (c)(3) of this section, which discusses purchasing costs. Purchasing costs must include the amount of allocable mixed service costs determined in paragraph (d)(3)(i)(F) of this section. Current year's purchases generally mean the taxpayer's section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.

(*3*) Current year's purchasing costs and current year's purchases, as defined in paragraph (d)(3)(i)(E)(*2*) of this section, do not include costs that are specifically described in §1.263A–1(e)(3)(ii) or cost reductions described in §1.471–3(e) that a taxpayer properly allocates entirely to property that has been sold.

(F) *Allocable mixed service costs.* (*1*) If a taxpayer allocates its mixed service costs to purchasing costs, storage costs, and handling costs using a method described in §1.263A–1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). However, if the taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios in paragraphs (d)(3)(i) (D) and (E) of this section is determined as follows:

$$\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$$

(*2*) Labor costs allocable to activity are defined as the total labor costs allocable to each particular activity (i.e., purchasing, handling, and storage), excluding labor costs included in mixed service costs. Total labor costs are defined as the total labor costs (excluding labor costs included in mixed service costs) that are incurred in the taxpayer's trade or business during the taxable year. See §1.263A–1(h)(6) for the definition of total mixed service costs.

(ii) *LIFO taxpayers electing simplified resale method*—(A) *In general.* Under the simplified resale method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under §1.472–8(e)) without regard its additional section 263A costs. Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional section 263A costs in making that determination.

(B) *LIFO increment.* If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of section

471 costs). The taxpayer then multiplies this amount by the combined absorption ratio. The resulting product is the additional section 263A costs that must be added to the taxpayer's increment for the year stated in terms of section 471 costs.

(C) *LIFO decrement*. If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. The additional section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. The additional section 263A costs that are applicable to the decrement are determined by multiplying the additional section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional section 263A costs) to the section 471 costs in the layer of that pool.

(iii) *Permissible variations of the simplified resale method*. The following variations of the simplified resale method are permitted:

(A) The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or

(B) Multiplication of the storage and handling costs absorption ratio in paragraph (d)(3)(i)(D) of this section by the total of section 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs.

(iv) *Examples*. The provisions of this paragraph (d)(3) are illustrated by the following examples:

Example 1. FIFO inventory method. (i) Taxpayer S uses the FIFO method of accounting for inventories. S's beginning inventory for 1994 (all of which was sold during 1994) was $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, S makes purchases of $10,000,000. In addition, S incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. S's purchases (section 471 costs) remaining in ending inventory at the end of 1994 are $3,000,000.

(ii) In 1994, S incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, S incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) S computes its purchasing costs absorption ratio for 1994 as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$460{,}000 + \$40{,}000}{\$10{,}000{,}000}$$

$$= \frac{\$500{,}000}{\$10{,}000{,}000}$$

$$= 5.0\%$$

(iv) S computes its storage and handling costs absorption ratio for 1994 as follows:

$$\frac{\text{Storage and handling costs}}{\begin{array}{c}\text{Beginning inventory}\\ \text{plus 1994 purchases}\end{array}} = \frac{(\$110{,}000+\$80{,}000)+(\$90{,}000+\$80{,}000)}{\$2{,}000{,}000+\$10{,}000{,}000}$$

$$= \frac{\$190{,}000+\$170{,}000}{\$12{,}000{,}000}$$

$$= \frac{\$360{,}000}{\$12{,}000{,}000}$$

$$= 3.0\%$$

(v) S's combined absorption ratio is 8.0 %, or the sum of the purchasing costs absorption ratio (5.0 %) and the storage and handling costs absorption ratio (3.0 %). Under the simplified resale method, S determines the additional section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its section 471 costs with respect to current year's purchases remaining in ending inventory:

$$\text{Additional section 263A costs} = 8.0\% \times \$3{,}000{,}000 = \$240{,}000$$

(vi) S adds this $240,000 to the $3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of $3,240,000.

Example 2. LIFO inventory method. (i) Taxpayer T uses a dollar-value LIFO inventory method. T's beginning inventory for 1994 is $2,100,000 (consisting of $2,000,000 of section 471 costs and $100,000 of additional section 263A costs). During 1994, T makes purchases of $10,000,000. In addition, T incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. T's 1994 LIFO increment is $1,000,000 ($3,000,000 of section 471 costs in ending inventory less $2,000,000 of section 471 costs in beginning inventory).

(ii) In 1994, T incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): purchasing—$100,000, storage—$200,000, and handling—$200,000. Accordingly, the following mixed service costs must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: purchasing—$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000); storage—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000); and handling—$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000).

(iii) Based on these facts, T determines that it has a combined absorption ratio of 8.0 %. To determine the additional section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0 %) by the $1,000,000 LIFO increment. Thus, T's additional section 263A costs allocable to its ending inventory are $80,000 ($1,000,000 multiplied by 8.0 %). This $80,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,080,000. T's ending inventory is $3,180,000 (its beginning inventory of $2,100,000 plus the $1,080,000 increment).

(iv) In 1995, T sells one-half of the inventory in its 1994 LIFO increment. T must include in its cost of goods sold for 1995 the amount of additional section 263A costs relating to this inventory, i.e., one-half of the $80,000 additional section 263A costs capitalized in 1994 ending inventory, or $40,000.

Example 3. LIFO Pools. (i) Taxpayer U begins its business in 1994, and adopts the LIFO inventory method. During 1994, U makes purchases of $10,000, and incurs $400 of purchasing costs, $350 of storage costs and $250 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper allocable share of mixed service costs.

(ii) U computes its purchasing costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$400}{\$10{,}000}$$

$$= 4.0\%$$

(iii) U computes its storage and handling costs absorption ratio for 1994, as follows:

$$\frac{\text{1994 storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{\$350 + \$250}{\$0 + \$10{,}000}$$

$$= \frac{\$600}{\$10{,}000}$$

$$= 6.0\%$$

(iv) U's combined absorption ratio is 10%, or the sum of the purchasing costs absorption ratio (4.0%) and the storage and handling costs absorption ratio (6.0%). At the end of 1994, U's ending inventory included $3,000 of current year purchases, contained in three LIFO pools (X, Y, and Z) as shown below. Under the simplified resale method, U computes its ending inventory for 1994 as follows:

1994	Total	X	Y	Z
Ending section 471 costs	$3,000	$1,600	$600	$800
Additional section 263A costs (10%)	300	160	60	80
1994 ending inventory	3,300	1,760	660	880

(v) During 1995, U makes purchases of $2,000 as shown below, and incurs $200 of purchasing costs, $325 of storage costs and $175 of handling costs. U's purchasing costs, storage costs, and handling costs include their proper share of mixed service costs. Moreover, U sold goods from pools X, Y, and Z having a total cost of $1,000. U computes its ending inventory for 1995 as follows.

(vi) U computes its purchasing costs absorption ratio for 1995:

$$\frac{\text{1995 purchasing costs}}{\text{1995 purchases}} = \frac{\$200}{\$2{,}000}$$

$$= 10.0\%$$

(vii) U computes its storage and handling costs absorption ratio for 1995:

$$\frac{\text{1995 storage and handling costs}}{\text{Beginning inventory plus 1995 purchases}} = \frac{\$325 + \$175}{\$3{,}000 + \$2{,}000}$$

$$= \frac{\$500}{\$5{,}000}$$

$$= 10.0\%$$

(viii) U's combined absorption ratio is 20.0%, or the sum of the purchasing costs absorption ratio (10.0%) and the storage and handling costs absorption ratio (10.0%).

1995	Total	X	Y	Z
Beginning section 471 costs	$3,000	$1,600	$600	$800
1995 section 471 costs	2,000	1,500	300	200
Section 471 cost of goods sold	(1,000)	(300)	(300)	(400)
1995 ending section 471 costs	4,000	2,800	600	600
Consisting of:				
1994 layer	2,800	1,600	600	600
1995 layer	1,200	1,200		
	4,000	2,800	600	600

1995	Total	X	Y	Z
Additional section 263A costs:				
1994 (10%)	280	160	60	60
1995 (20%)	240	240		
	520	400	60	60
1995 ending inventory	4,520	3,200	660	660

(ix) In 1995, U experiences a $200 decrement in Pool Z. Thus, U must charge the additional section 263A costs incurred in prior years applicable to the decrement to 1995's cost of goods sold. To do so, U determines a ratio by dividing the decrement by the section 471 costs in the 1994 layer ($200 divided by $800, or 25%). U then multiplies this ratio (25%) by the additional section 263A costs in the 1994 layer ($80) to determine the additional section 263A costs applicable to the decrement ($20). Therefore, $20 is taken into account by U in 1995 as part of its cost of goods sold ($80 multiplied by 25%).

(4) *Simplified resale method with historic absorption ratio election*—(i) *In general.* This paragraph (d)(4) permits resellers using the simplified resale method to elect a historic absorption ratio in determining additional section 263A costs allocable to eligible property remaining on hand at the close of their taxable years. Except as provided in paragraph (d)(4)(v) of this section, a taxpayer may only make a historic absorption ratio election if it has used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election. The historic absorption ratio is used in lieu of an actual combined absorption ratio computed under paragraph (d)(3)(i)(C)(*1*) of this section and is based on costs capitalized by a taxpayer during its test period. If elected, the historic absorption ratio must be used for the qualifying period described in paragraph (d)(4)(ii)(C) of this section.

(ii) *Operating rules and definitions*—(A) *Historic absorption ratio.* (*1*) The historic absorption ratio is equal to the following ratio:

$$\frac{\text{Additional section 263A costs incurred during the test period}}{\text{Section 471 costs incurred during the test period}}$$

(*2*) Additional section 263A costs incurred during the test period are defined as the sum of the products of the combined absorption ratios (defined in paragraph (d)(3)(i)(C)(*1*) of this section) multiplied by a taxpayer's section 471 costs incurred with respect to purchases, for each taxable year of the test period.

(*3*) Section 471 costs incurred during the test period mean the section 471 costs described in §1.263A–1(d)(2) that a taxpayer incurs generally with respect to its purchases during the test period described in paragraph (d)(4)(ii)(B) of this section.

(B) *Test period*—(*1*) *In general.* The test period is generally the three taxable-year period immediately prior to the taxable year that the historic absorption ratio is elected.

(*2*) *Updated test period.* The test period begins again with the beginning of the first taxable year after the close of a qualifying period (as defined in paragraph (d)(4)(ii)(C) of this section). This new test period, the updated test period, is the three taxable-year period beginning with the first taxable year after the close of the qualifying period.

(C) *Qualifying period*—(*1*) *In general.* A qualifying period includes each of the first five taxable years beginning with the first taxable year after a test period (or updated test period).

(*2*) *Extension of qualifying period.* In the first taxable year following the close of each qualifying period (e.g., the sixth taxable year following the test period), the taxpayer must compute the actual combined absorption ratio under the simplified resale method. If the actual combined absorption ratio computed for this taxable year (the recomputation year) is within one-half of one percentage point (plus or minus) of the historic absorption ratio used in determining capitalizable costs for the qualifying period (i.e., the previous five taxable years), the qualifying period must be extended to include the recomputation year and the following five taxable years, and the taxpayer must continue to use the historic absorption ratio throughout the extended qualifying period. If, however, the actual combined absorption ratio computed for the recomputation year is not within one-half of one percentage point (plus or minus) of the historic absorption ratio, the taxpayer must use actual combined absorption ratios beginning with the recomputation year under the simplified resale method and throughout the updated test period. The taxpayer must resume using the historic absorption ratio (determined with reference to the updated test period) in the third taxable year following the recomputation year.

(iii) *Method of accounting*—(A) *Adoption and use.* The election to use the historic absorption ratio is a method of accounting. A taxpayer using the simplified resale method may elect the historic absorption ratio in any taxable year if permitted under this paragraph (d)(4), provided the taxpayer has not obtained the Commissioner's consent to revoke the historic absorption ratio election within its prior six taxable years. The election is to be effected on a cut-off basis, and thus, no adjustment under section 481(a) is required or permitted. The use of a historic absorption ratio has no effect on other methods of accounting adopted by the taxpayer and used in conjunction with the simplified resale method in determining its section 263A costs. Accordingly, in computing its actual combined absorption ratios, the taxpayer must use the same methods of accounting used in computing its historic absorption ratio during its most recent test period unless the taxpayer obtains the consent of the Commissioner. Finally, for purposes of this paragraph (d)(4)(iii)(A), the recomputation of the historic absorption ratio during an updated test period and the change from a historic absorption ratio to an actual combined absorption ratio during an updated test period by reason of the requirements of this paragraph (d)(4) are not considered changes in methods of accounting under section 446(e) and, thus, do not require the consent of the Commissioner or any adjustments under section 481(a).

(B) *Revocation of election.* A taxpayer may only revoke its election to use the historic absorption ratio with the consent of the Commissioner in a manner prescribed under section 446(e) and the regulations thereunder. Consent to the change for any taxable year that is included in the qualifying period (or an extended qualifying period) will be granted only upon a showing of unusual circumstances.

(iv) *Reporting and recordkeeping requirements*—(A) *Reporting.* A taxpayer making an election under this paragraph (d)(4) must attach a statement to its federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the simplified resale method during its first test period. This statement must disclose the historic absorption ratio to be used by the taxpayer during its qualifying period. A similar statement must be attached to the federal income tax return for the first taxable year within any subsequent qualifying period (i.e., after an updated test period).

(B) *Recordkeeping.* A taxpayer must maintain all appropriate records and details supporting the historic absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular historic absorption ratio in determining additional section 263A costs capitalized to eligible property.

(v) (A) *Transition to elect historic absorption ratio.* Taxpayers will be permitted to elect a historic absorption ratio in their first, second, or third taxable year beginning after December 31, 1993, under such terms and conditions as may be prescribed by the Commissioner. Taxpayers are eligible to make an election under these transition rules whether or not they previously used the simplified resale method. A taxpayer making such an election must recompute (or compute) its additional section 263A costs, and thus, its historic absorption ratio for its first test period as if the rules prescribed in this section and §§1.263A–1 and 1.263A–2 had applied throughout the test period.

(B) *Transition to revoke historic absorption ratio*. Notwithstanding the requirements provided in paragraph (d)(4)(iii)(B) of this section regarding revocations of the historic absorption ratio during a qualifying period, a taxpayer will be permitted to revoke the historic absorption ratio in their first, second, or third taxable year ending on or after *November 20, 2018*, under such administrative procedures and with terms and conditions prescribed by the Commissioner.

(vi) *Example*. The provisions of this paragraph (d)(4) are illustrated by the following example:

Example. (i) Taxpayer V uses the FIFO method of accounting for inventories and in 1994 elects to use the historic absorption ratio with the simplified resale method. After recomputing its additional section 263A costs in accordance with the transition rules of paragraph (d)(4)(v) of this section, V identifies the following costs incurred during the test period:

1991:
Add'l section 263A costs—$100
Section 471 costs—$3,000
1992:
Add'l section 263A costs—$200
Section 471 costs—$4,000
1993:
Add'l section 263A costs—$300
Section 471 costs—$5,000

(ii) Therefore, V computes a 5% historic absorption ratio determined as follows:

$$\text{Historic absorption ratio} = \frac{\$100 + 200 + 300}{\$3000 + 4{,}000 + 5{,}000} = \frac{\$600}{\$12{,}000} = 5\%$$

(iii) In 1994, V incurs $10,000 of section 471 costs of which $3,000 remain in inventory at the end of the year. Under the simplified resale method using a historic absorption ratio, V determines the additional section 263A costs allocable to its ending inventory by multiplying its historic ratio (5%) by the section 471 costs remaining in its ending inventory:

$$\text{Additional section 263A costs} = 5\% \times \$3{,}000 = \$150$$

(iv) To determine its ending inventory under section 263A, V adds the additional section 263A costs allocable to ending inventory to its section 471 costs remaining in ending inventory ($3,150 = $150 + $3,000). The balance of V's additional section 263A costs incurred during 1994 is taken into account in 1994 as part of V's cost of goods sold.

(v) V's qualifying period ends as of the close of its 1998 taxable year. Therefore, 1999 is a recomputation year in which V must compute its actual combined absorption ratio. V determines its actual absorption ratio for 1999 to be 5.25% and compares that ratio to its historic absorption ratio (5.0%). Therefore, V must continue to use its historic absorption ratio of 5.0% throughout an extended qualifying period, 1999 through 2004 (the recomputation year and the following five taxable years).

(vi) If, instead, V's actual combined absorption ratio for 1999 were not between 4.5% and 5.5%, V's qualifying period would end and V would be required to compute a new historic absorption ratio with reference to an updated test period of 1999, 2000, and 2001. Once V's historic absorption ratio is determined for the updated test period, it would be used for a new qualifying period beginning in 2002.

(5) *Additional simplified methods for resellers*. The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(e) *Cross reference*. See §1.6001–1(a) regarding the duty of taxpayers to keep such records as are sufficient to establish the amount of gross income, deductions, etc.

(f) *Applicability dates.* (1) Paragraphs (d)(3)(i)(C)(*3*), (d)(3)(i)(D)(*3*), and (d)(3)(i)(E)(*3*) of this section apply for taxable years ending on or after January 13, 2014.

(2) The rules set forth in the second sentence of paragraph (a)(1) of this section, paragraphs (a)(2)(ii) and (iii) of this section, the third sentence of paragraph (a)(3) of this section, and paragraphs (a)(4)(ii) and (a)(5) of this section apply for taxable years beginning on or after January 5, 2021 . However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (f)(2), provided the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

[T.D. 8482, 58 FR 42224, Aug. 9, 1993; 58 FR 47784, Sept. 10, 1993; 59 FR 3319, Jan. 21, 1994, as amended by T.D. 8559, 59 FR 39962, Aug. 5, 1994, T.D. 9652, 79 FR 2097, Jan. 13, 2014; T.D. 9843, 83 FR 58498, Nov. 20, 2018; T.D. 9942, 86 FR 266, Jan. 5, 2021]

§ 1.263A–4 Rules for property produced in a farming business.

(a) *Introduction*—(1) *In general.* This section provides guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(5) of this section. Except as otherwise provided by the rules of this section, the general rules of §§ 1.263A–1 through 1.263A–3 and §§ 1.263A–7 through 1.263A–15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including both plants and animals, is engaged in the production of property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of this property. The direct and indirect costs of producing plants or animals generally include preparatory costs allocable to the plant or animal and preproductive period costs of the plant or animal. Except as provided in paragraphs (a)(2), (a)(3), and (e) of this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) *Exception*—(i) *In general.* Section 263A does not apply to the costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals in a farming business, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3).

(ii) *Tax shelter*—(A) *In general.* A farming business is considered a tax shelter, and thus a taxpayer prohibited from using the cash method under section 448(a)(3), if the farming business is—

(*1*) A farming syndicate as defined in section 461(k); or

(*2*) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(B) *Presumption.* Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (a)(2):

Example 1. Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 to use an accrual method or prohibited by section 448(a)(3) from using the cash method. Accordingly, Farmer A qualifies for the exception described in this paragraph (a)(2). Since the trees have a preproductive period in excess of 2 years, Farmer A must capitalize the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of the trees. Since the annual crop has a preproductive period of 2 years or less, Farmer A is not required to capitalize the costs of producing the crops.

Example 2. Assume the same facts as *Example 1,* except that Farmer A is required by section 447 to use an accrual method or prohibited by 448(a)(3) from using the cash method. Farmer A does not qualify for the exception described in this paragraph (a)(2). Farmer A is required to capitalize the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of the trees and crops.

(3) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see § 1.263A–1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and § 1.448–2(c).

(4) *Costs required to be capitalized or inventoried under another provision.* The exceptions from capitalization provided in paragraphs (a)(2), (a)(3), (d) and (e) of this section do not apply to any cost that is required to be capitalized or inventoried under another Internal Revenue Code or regulatory provision, such as section 263 or 471.

(5) *Farming business*—(i) *In general.* A farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than 6 years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this section, the term harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another. Similarly, merely buying and reselling plants or animals grown or raised entirely by another is not raising an agricultural or horticultural commodity. A taxpayer is engaged in raising a plant or animal, rather than the mere resale of a plant or animal, if the plant or animal is held for further cultivation and development prior to sale. In determining whether a plant or animal is held for further cultivation and development prior to sale, consideration will be given to all of the facts and circumstances, including: the value added by the taxpayer to the plant or animal through agricultural or horticultural processes; the length of time between the taxpayer's acquisition of the plant or animal and the time that the taxpayer makes the plant or animal available for sale; and in the case of a plant, whether the plant is kept in the container in which purchased, replanted in the ground, or replanted in a series of larger containers as it is grown to a larger size.

(A) *Plant.* A plant produced in a farming business includes, but is not limited to, a fruit, nut, or other crop bearing tree, an ornamental tree, a vine, a bush, sod, and the crop or yield of a plant that will have more than one crop or yield raised by the taxpayer. Sea plants are produced in a farming business if they are tended and cultivated as opposed to merely harvested.

(B) *Animal.* An animal produced in a farming business includes, but is not limited to, any stock, poultry or other bird, and fish or other sea life raised by the taxpayer. Thus, for example, the term animal may include a cow, chicken, emu, or salmon raised by the taxpayer. Fish and other sea life are produced in a farming business if they are raised on a fish farm. A fish farm is an area where fish or other sea life are grown or raised as opposed to merely caught or harvested.

(ii) *Incidental activities*—(A) *In general.* A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. For example, a taxpayer in the trade or business of growing fruits and vegetables may harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the trade or business of farming with respect to the growing of fruits and vegetables and the processing activities incident to their harvest.

(B) *Activities that are not incidental.* Farming business does not include the processing of commodities or products beyond those activities that are normally incident to the growing, raising, or harvesting of such products.

(iii) *Examples*. The following examples illustrate the provisions of this paragraph (a)(5):

Example 1. Individual A operates a retail nursery. Individual A has three categories of plants. The first category is comprised of plants that Individual A grows from seeds or cuttings. The second category is comprised of plants that Individual A purchases in containers and grows for a period of from several months to several years. Individual A replants some of these plants in the ground. The others are replanted in a series of larger containers as they grow. The third category is comprised of plants that are purchased by Individual A in containers. Individual A does not grow these plants to a larger size before making them available for resale. Instead, Individual A makes these plants available for resale, in the container in which purchased, shortly after receiving them. Thus, no value is added to these plants by Individual A through horticultural processes. Individual A also sells soil, mulch, chemicals, and yard tools. Individual A is producing property in the farming business with respect to the first two categories of plants because these plants are held for further cultivation and development prior to sale. The plants in the third category are not held for further cultivation and development prior to sale and, therefore, are not regarded as property produced in a farming business for purposes of section 263A. Accordingly, Individual A must account for the third category of plants, along with the soil, mulch, chemicals, and yard tools, as property acquired for resale. If Individual A's average annual gross receipts are less than $10 million,

Example 2. Individual B is in the business of growing and harvesting wheat and other grains. Individual B also processes grain that Individual B has harvested in order to produce breads, cereals, and other similar food products, which Individual B then sells to customers in the course of its business. Although Individual B is in the farming business with respect to the growing and harvesting of grain, Individual B is not in the farming business with respect to the processing of such grain to produce the food products.

Example 3. Individual C is in the business of raising poultry and other livestock. Individual C also operates a meat processing operation in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Individual C's customers. Although Individual C is in the farming business with respect to the raising of poultry and other livestock, Individual C is not in the farming business with respect to the slaughtering, processing, packaging, and canning of such animals to produce the food products.

(b) *Application of section 263A to property produced in a farming business*—(1) *In general*. Unless otherwise provided in this section, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period). Section 1.263A–1(e) describes the types of direct and indirect costs that generally must be capitalized by taxpayers under section 263A and paragraphs (b)(1)(i) and (ii) of this section provide specific examples of the types of costs typically incurred in the trade or business of farming. For purposes of this section, soil and water conservation expenditures that a taxpayer has elected to deduct under section 175 and fertilizer that a taxpayer has elected to deduct under section 180 are not subject to capitalization under section 263A, except to the extent these costs are required to be capitalized as a preproductive period cost of a plant or animal.

(i) *Plants*. The costs of producing a plant typically required to be capitalized under section 263A include the costs incurred so that the plant's growing process may begin (preparatory costs), such as the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing the plant during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, irrigation, pruning, soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), fertilizing (including costs that the taxpayer has elected to deduct under section 180), frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under section 263A(f).

(ii) *Animals*. The costs of producing an animal typically required to be capitalized under section 263A include the costs incurred so that the animal's raising process may begin (preparatory costs), such as the acquisition costs of the animal, and the costs of raising or caring for such animal during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and Federal income taxes), and interest required to be capitalized under section 263A(f).

(2) *Preproductive period*—(i) *Plant*—(A) *In general.* The preproductive period of property produced in a farming business means—

(*1*) In the case of a plant that will have more than one crop or yield (for example, an orange tree), the period before the first marketable crop or yield from such plant;

(*2*) In the case of the crop or yield of a plant that will have more than one crop or yield (for example, the orange), the period before such crop or yield is disposed of; or

(*3*) In the case of any other plant, the period before such plant is disposed of.

(B) *Applicability of section 263A.* For purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant. The Commissioner will publish a noninclusive list of plants with a nationwide weighted average preproductive period in excess of 2 years. In the case of other plants grown in commercial quantities in the United States, the nationwide weighted average preproductive period must be determined based on available statistical data. For all other plants, the taxpayer is required, at or before the time the seed or plant is acquired or planted, to reasonably estimate the preproductive period of the plant. If the taxpayer estimates a preproductive period in excess of 2 years, the taxpayer must capitalize the costs of producing the plant. If the estimate is reasonable, based on the facts in existence at the time it is made, the determination of whether section 263A applies is not modified at a later time even if the actual length of the preproductive period differs from the estimate. The actual length of the preproductive period will, however, be considered in evaluating the reasonableness of the taxpayer's future estimates. The nationwide weighted average preproductive period or the estimated preproductive period is only used for purposes of determining whether the preproductive period of a plant is greater than 2 years.

(C) *Actual preproductive period.* The plant's actual preproductive period is used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

(*1*) *Beginning of the preproductive period.* The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant. In the case of a taxpayer that acquires plants that have already been permanently planted, or plants that are tended by the taxpayer or another prior to permanent planting, the actual preproductive period of the plant begins upon acquisition of the plant by the taxpayer. In the case of the crop or yield of a plant that will have more than one crop or yield, the actual preproductive period begins when the plant has become productive in marketable quantities and the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

(*2*) *End of the preproductive period*—(i) *In general.* In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities. In the case of any other plant (including the crop or yield of a plant that will have more than one crop or yield), the actual preproductive period ends when the plant, crop, or yield is sold or otherwise disposed of. Field costs, such as irrigating, fertilizing, spraying and pruning, that are incurred after the harvest of a crop or yield but before the crop or yield is sold or otherwise disposed of are not required to be included in the preproductive period costs of the harvested crop or yield because they do not benefit and are unrelated to the harvested crop or yield.

(ii) *Marketable quantities.* A plant that will have more than one crop or yield becomes productive in marketable quantities once a crop or yield is produced in sufficient quantities to be harvested and marketed in the ordinary course of the taxpayer's business. Factors that are relevant to determining whether a crop or yield is produced in sufficient quantities to be harvested and marketed in the ordinary course include: whether the crop or yield is harvested that is more than *de minimis,* although it may be less than expected at the maximum bearing stage, based on a comparison of the quantities per acre harvested in the year in question to the quantities per acre expected to be harvested when the plant reaches full maturity; and whether the sales proceeds exceed the costs of harvest and make a reasonable contribution to an allocable share of farm expenses.

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

Example 1. (i) Farmer A, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer A acquires 1 year-old plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years. The particular plants grown by Farmer A do not begin to produce in marketable quantities until 3 years and 6 months after they are planted by Farmer A.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer A is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer A must begin to capitalize the preproductive period costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer A must continue to capitalize preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer A must capitalize the preproductive period costs for a period of 3 years and 6 months (that is, until the plants are 4 years and 6 months old), notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 4 years.

Example 2. (i) Farmer B, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. The nationwide weighted average preproductive period of the plant is 2 years and 5 months. Farmer B acquires 1 month-old plants by purchasing them from an unrelated party, Corporation B. Farmer B enters into a contract with Corporation B under which Corporation B will retain and tend the plants for 7 months following the sale. At the end of 7 months, Farmer B takes possession of the plants and plants them in the permanent orchard. The plants become productive in marketable quantities 1 year and 11 months after they are planted by Farmer B.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize the preproductive period costs when the purchase occurs. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize the preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 2 years and 6 months (the 7 months the plants are tended by Corporation B and the 1 year and 11 months after the plants are planted by Farmer B), that is, until the plants are 2 years and 7 months old, notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 2 years and 5 months.

Example 3. (i) Assume the same facts as in *Example 2,* except that Farmer B acquires the plants by purchasing them from Corporation B when the plants are 8 months old and that the plants are planted by Farmer B upon acquisition.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the costs of producing the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize the preproductive period costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize the preproductive period costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 1 year and 11 months.

Example 4. (i) Farmer C, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer C acquires 1 month-old plants from an unrelated party and plants them immediately. The nationwide weighted average preproductive period of the plant is 2 years and 3 months. The particular plants grown by Farmer C begin to produce in marketable quantities 1 year and 10 months after they are planted by Farmer C.

(ii) Since the plants are deemed to have a nationwide weighted average preproductive period in excess of 2 years, Farmer C is required to capitalize the costs of producing the plants, notwithstanding the fact that the particular plants grown by Farmer C become productive in less than 2 years. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer C must begin to capitalize the preproductive period costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer C properly ceases capitalization of preproductive period costs when the plants become productive in marketable quantities (that is, 1 year and 10 months after they are planted, which is when they are 1 year and 11 months old).

Example 5. (i) Farmer D, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are not grown in commercial quantities in the United States. Farmer D acquires and plants the plants when they are 1 year old and estimates that they will become productive in marketable quantities 3 years after planting. Thus, at the time the plants are acquired and planted Farmer D reasonably estimates that the plants will have a preproductive period of 4 years. The actual plants grown by Farmer D do not begin to produce in marketable quantities until 3 years and 6 months after they are planted by Farmer D.

(ii) Since the plants have an estimated preproductive period in excess of 2 years, Farmer D is required to capitalize the costs of producing the plants. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer D must begin to capitalize the preproductive period costs when it acquires and plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer D must continue to capitalize the preproductive period costs until the plants begin to produce in marketable quantities. Thus, Farmer D must capitalize the preproductive period costs of the plants for a period of 3 years and 6 months (that is, until the plants are 4 years and 6 months old), notwithstanding the fact that Farmer D estimated that the plants would become productive after 4 years.

Example 6. (i) Farmer E, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section grows plants from seed. The plants are not grown in commercial quantities in the United States. The plants do not have more than 1 crop or yield. At the time the seeds are planted Farmer E reasonably estimates that the plants will have a preproductive period of 1 year and 10 months. The actual plants grown by Farmer E are not ready for harvesting and disposal until 2 years and 2 months after the seeds are planted by Farmer E.

(ii) Because Farmer E's estimate of the preproductive period (which was 2 years or less) was reasonable at the time made based on the facts, Farmer E will not be required to capitalize the costs of producing the plants under section 263A, notwithstanding the fact that the actual preproductive period of the plants exceeded 2 years. See paragraph (b)(2)(i)(B) of this section. However, Farmer E must take the actual preproductive period of the plants into consideration when making future estimates of the preproductive period of such plants.

Example 7. (i) Farmer F, a calendar year taxpayer that does not qualify for the exception in paragraph (a)(2) of this section, grows trees that will have more than one crop. Farmer F acquires and plants the trees in April, Year 1. On October 1, Year 6, the trees become productive in marketable quantities.

(ii) The costs of producing the plant, including the preproductive period costs incurred by Farmer F on or before October 1, Year 6, are capitalized to the trees. Preproductive period costs incurred after October 1, Year 6, are capitalized to a crop when incurred during the preproductive period of the crop and deducted as a cost of maintaining the tree when incurred between the disposal of one crop and the appearance of the next crop. See paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(*1*) and (b)(2)(i)(C)(*2*) of this section.

Example 8. (i) Farmer G, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, produces fig trees on 10 acres of land. The fig trees are grown in commercial quantities in the United States and have a nationwide weighted average preproductive period in excess of 2 years. Farmer G acquires and plants the fig trees in their permanent grove during Year 1. When the fig trees are mature, Farmer G expects to harvest 10x tons of figs per acre. At the end of Year 4, Farmer G harvests .5x tons of figs per acre that it sells for $100x. During Year 4, Farmer G incurs expenses related to the fig operation of: $50x to harvest the figs and transport them to market and other direct and indirect costs related to the fig operation in the amount of $1000x.

(ii) Since the fig trees have a preproductive period in excess of 2 years, Farmer G is required to capitalize the costs of producing the fig trees. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer G must continue to capitalize preproductive period costs to the trees until they become productive in marketable quantities. The following factors weigh in favor of a determination that the fig trees did not become productive in Year 4: the quantity of harvested figs is *de minimis* based on the fact that the yield is only 5 percent of the expected yield at maturity and the proceeds from the sale of the figs are sufficient, after covering the costs of harvesting and transporting the figs, to cover only a negligible portion of the allocable farm expenses. Based on these facts and circumstances, the fig trees did not become productive in marketable quantities in Year 4.

(ii) *Animal.* An animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period costs with respect to a particular animal.

(A) *Beginning of the preproductive period.* The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

(B) *End of the preproductive period.* In the case of an animal that will be used in the trade or business of farming (for example, a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (for example, a breeding cow), the preproductive period ends when the animal produces (for example, gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

(C) *Allocation of costs between animal and yields.* In the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield using any reasonable method. Any depreciation allowance on the animal may be allocated entirely to the yield. Costs incurred after the beginning of the preproductive period of the second yield, but before the first yield is weaned from the animal must be allocated between the first and second yield using any reasonable method. However, a taxpayer may elect to allocate these costs entirely to the second yield. An allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

(c) *Inventory methods*—(1) *In general.* Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See § 1.471–6. Under the unit-livestock-price method, unit prices must include all costs required to be capitalized under section 263A. A taxpayer using the unit-livestock-price method may elect to use the cost allocation methods in § 1.263A–1(f) or 1.263A–2(b) to allocate its direct and indirect costs to the property produced in the business of farming. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price as modified by this paragraph (c)(1). Tax shelters, as defined in paragraph (a)(2)(ii) of this section, that use the unit-livestock-price method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by section 447 to use an accrual method or prohibited by section 448(a)(3) from using the cash method that use the unit-livestock-price method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit-livestock-price method.

(2) *Available for property used in a trade or business.* The farm-price method or the unit-livestock-price method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit-livestock-price method to account for the costs of raising livestock that will be used in the trade or business of farming (for example, a breeding animal or a dairy cow) even though the property in question is not inventory property.

(3) *Exclusion of property to which section 263A does not apply.* Notwithstanding a taxpayer's use of the farm-price method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not required, solely by such use, to use the farm-price method with respect to farm property to which the provisions of section 263A do not apply. Thus, for example, assume Farmer A raises fruit trees that have a preproductive period in excess of 2 years and to which the provisions of section 263A, therefore, apply. Assume also that Farmer A raises cattle and is not required to use an accrual method by section 447 or prohibited from using the cash method by section 448(a)(3). Because Farmer A qualifies for the exception in paragraph (a)(2) of this section, Farmer A is not required to capitalize the costs of raising the cattle. Although Farmer A may use the farm-price method with respect to the fruit trees, Farmer A is not required to use the farm-price method with respect to the cattle. Instead, Farmer A's accounting for the cattle is determined under other provisions of the Code and regulations.

(d) *Election not to have section 263A apply under section 263A(d)(3)*—(1) *Introduction.* This paragraph (d) permits certain taxpayers to make an election not to have the rules of this section apply to any plant produced in a farming business conducted by the electing taxpayer. Except as provided in paragraph (d)(5) and (6) of this section, the election is a method of accounting under section 446. An election made under section 263A(d)(3) and this paragraph (d) is revocable only with the consent of the Commissioner.

(2) *Availability of the election.* The election described in this paragraph (d) is available to any taxpayer that produces plants in a farming business, except that no election may be made by a corporation, partnership, or tax shelter required to use an accrual method under section 447 or prohibited from using the cash method by section 448(a)(3). Moreover, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove (or any part thereof) incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove (including costs incurred prior to the permanent planting). If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(3) *Time and manner of making the election*—(i) *Automatic election.* A taxpayer makes the election under this paragraph (d) by not applying the rules of section 263A to determine the capitalized costs of plants produced in a farming business and by applying the special rules in paragraph (d)(4) of this section on its original return for the first taxable year in which the taxpayer is otherwise required to capitalize section 263A costs. Thus, in order to be treated as having made the election under this paragraph (d), it is necessary to report both income and expenses in accordance with the rules of this paragraph (d) (for example, it is necessary to use the alternative depreciation system as provided in paragraph (d)(4)(ii) of this section). For example, a farmer who deducts costs that are otherwise required to be capitalized under section 263A but fails to use the alternative depreciation system under section 168(g)(2) for applicable property placed in service has not made an election under this paragraph (d) and is not in compliance with the provisions of section 263A.

(ii) *Nonautomatic election*. Except as provided in paragraphs (d)(5) and (6) of this section, a taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) of this section must obtain the consent of the Commissioner to make the election by filing a Form 3115, *Application for Change in Method of Accounting*, in accordance with §1.446–1(e)(3).

(4) *Special rules*. If the election under this paragraph (d) is made, the taxpayer is subject to the special rules in this paragraph (d)(4).

(i) *Section 1245 treatment*. The plant produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of the plant is recaptured (that is, treated as ordinary income) to the extent of the total amount of the deductions that, but for the election, would have been required to be capitalized with respect to the plant. In calculating the amount of gain that is recaptured under this paragraph (d)(4)(i), a taxpayer may use the farm-price method or another simplified method permitted under these regulations in determining the deductions that otherwise would have been capitalized with respect to the plant.

(ii) *Required use of alternative depreciation system*. If the taxpayer or a related person makes an election under this paragraph (d), the alternative depreciation system (as defined in section 168(g)(2)) must be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of an election under this paragraph (d) will not prevent a taxpayer from making an election under section 179 to deduct certain depreciable business assets.

(iii) *Related person*—(A) *In general*. For purposes of this paragraph (d)(4), related person means—

(*1*) The taxpayer and members of the taxpayer's family;

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family;

(*3*) A corporation and any other corporation that is a member of the same controlled group (within the meaning of section 1563(a)(1)); and

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

(B) *Members of family*. For purposes of this paragraph (d)(4)(iii), the terms "members of the taxpayer's family", and "members of family" (for purposes of applying section 318(a)(1)), means the spouse of the taxpayer (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and any of the taxpayer's children (including legally adopted children) who have not reached the age of 18 as of the last day of the taxable year in question.

(5) *Revocation of section 263A(d)(3) election to permit exemption under section 263A(i)*. A taxpayer that elected under section 263A(d)(3) and paragraph (d)(3) of this section not to have section 263A apply to any plant produced in a farming business that wants to revoke its section 263A(d)(3) election, and in the same taxable year, apply the small business taxpayer exemption under section 263A(i) and §1.263A–1(j) may revoke the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii)(b) of this chapter). A revocation of the taxpayer's section 263A(d)(3) election under this paragraph (d)(5) is not a change in method of accounting under sections 446 and 481 and §§1.446–1 and 1.481–1 through 1.481–5.

(6) *Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election*. A taxpayer whose method of accounting is to not capitalize costs under section 263A based on the exemption under section 263A(i), that becomes ineligible to use the exemption under section 263A(i), and is eligible and wants to elect under section 263A(d)(3) for this same taxable year to not capitalize costs under section 263A for any plant produced in the taxpayer's farming business, must make the election in accordance with the applicable administrative guidance as published in the Internal Revenue

Bulletin (*see* § 601.601(d)(2)(ii)(b) of this chapter). An election under section 263A(d)(3) made in accordance with this paragraph (d)(6) is not a change in method of accounting under sections 446 and 481 and §§ 1.446–1 and 1.481–1 through 1.481–5.

(7) *Examples*. The following examples illustrate the provisions of this paragraph (d):

Example 1. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows apple trees that have a preproductive period greater than 2 years. In addition, Farmer A grows and harvests wheat and other grains. Farmer A elects under this paragraph (d) not to have the rules of section 263A apply to the costs of growing the apple trees.

(ii) In accordance with paragraph (d)(4) of this section, Farmer A is required to use the alternative depreciation system described in section 168(g)(2) with respect to all property used predominantly in any farming business in which Farmer A engages (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including trees and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated as provided in section 168(g)(2).

Example 2. Assume the same facts as in *Example 1*, except that Farmer A and members of Farmer A's family (as defined in paragraph (d)(4)(iii)(B) of this section) also own 51 percent (in value) of the interests in Partnership P, which is engaged in the trade or business of growing and harvesting corn. Partnership P is a related person to Farmer A under the provisions of paragraph (d)(4)(iii) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g)(2) also apply to any property used predominantly in a trade or business of farming which Partnership P places in service during a year for which an election made by Farmer A is in effect.

(e) *Exception for certain costs resulting from casualty losses*—(1) *In general*. Section 263A does not require the capitalization of costs that are attributable to the replanting, cultivating, maintaining, and developing of any plants bearing an edible crop for human consumption (including, but not limited to, plants that constitute a grove, orchard, or vineyard) that were lost or damaged while owned by the taxpayer by reason of freezing temperatures, disease, drought, pests, or other casualty (replanting costs). Such replanting costs may be incurred with respect to property other than the property on which the damage or loss occurred to the extent the acreage of the property with respect to which the replanting costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. This paragraph (e) applies only to the replanting of plants of the same type as those lost or damaged. This paragraph (e) applies to plants replanted on the property on which the damage or loss occurred or property of the same or lesser acreage in the United States irrespective of differences in density between the lost or damaged and replanted plants. Plants bearing crops for human consumption are those crops normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (e) because that crop is not normally eaten or drunk by humans.

(2) *Ownership*. Replanting costs described in paragraph (e)(1) of this section generally must be incurred by the taxpayer that owned the property at the time the plants were lost or damaged. Paragraph (e)(1) of this section will apply, however, to costs incurred by a person other than the taxpayer that owned the plants at the time of damage or loss if—

(i) The taxpayer that owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants at all times during the taxable year in which the replanting costs are paid or incurred; and

(ii) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintaining, or developing of such plants during the taxable year in which the replanting costs are paid or incurred. A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A(e)(6).

(3) *Examples.* The following examples illustrate the provisions of this paragraph (e):

Example 1. (i) Farmer A grows cherry trees that have a preproductive period in excess of 2 years and produce an annual crop. These cherries are normally eaten by humans. Farmer A grows the trees on a 100 acre parcel of land (parcel 1) and the groves of trees cover the entire acreage of parcel 1. Farmer A also owns a 150 acre parcel of land (parcel 2) that Farmer A holds for future use. Both parcels are in the United States. In 2000, the trees and the irrigation and drainage systems that service the trees are destroyed in a casualty (within the meaning of paragraph (e)(1) of this section). Farmer A installs new irrigation and drainage systems on parcel 1, purchases young trees (seedlings), and plants the seedlings on parcel 1.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. In accordance with paragraph (e)(1) of this section, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A.

Example 2. (i) Assume the same facts as in *Example 1* except that Farmer A decides to replant the seedlings on parcel 2 rather than on parcel 1. Accordingly, Farmer A installs the new irrigation and drainage systems on 100 acres of parcel 2 and plants seedlings on those 100 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. Because the acreage of the related portion of parcel 2 does not exceed the acreage of the destroyed orchard on parcel 1, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A. See paragraph (e)(1) of this section.

Example 3. (i) Assume the same facts as in *Example 1* except that Farmer A replants the seedlings on parcel 2 rather than on parcel 1, and Farmer A additionally decides to expand its operations by growing 125 rather than 100 acres of trees. Accordingly, Farmer A installs new irrigation and drainage systems on 125 acres of parcel 2 and plants seedlings on those 125 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized. The costs of planting, cultivating, developing, and maintaining 100 acres of the trees during their preproductive period are not required to be capitalized by section 263A. The costs of planting, cultivating, maintaining, and developing the additional 25 acres are, however, subject to capitalization under section 263A. See paragraph (e)(1) of this section.

(4) *Special rule for citrus and almond groves*—(i) *In general.* The exception in this paragraph (e) is available with respect to replanting costs of a citrus or almond grove incurred prior to the close of the fourth taxable year after replanting, notwithstanding the taxpayer's election to have section 263A not apply (described in paragraph (d) of this section).

(ii) *Example.* The following example illustrates the provisions of this paragraph (e)(4):

Example. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows citrus trees that have a preproductive period of 5 years. Farmer A elects, under paragraph (d) of this section, not to have section 263A apply. This election, however, is unavailable with respect to the costs of producing a citrus grove incurred within the first 4 years beginning with the year the trees were planted. See paragraph (d)(2) of this section. In year 10, after the citrus grove has become productive in marketable quantities, the citrus grove is destroyed by a casualty within the meaning of paragraph (e)(1) of this section. In year 10, Farmer A acquires and plants young citrus trees in the same grove to replace those destroyed by the casualty.

(ii) Farmer A must capitalize the costs of producing the citrus grove incurred before the close of the fourth taxable year beginning with the year in which the trees were permanently planted. As a result of the election not to have section 263A apply, Farmer A may deduct the preproductive period costs incurred in the fifth year. In year 10, Farmer A must capitalize the acquisition cost of the young trees. However, the costs of planting, cultivating, developing, and maintaining the young trees that replace those destroyed by the casualty are exempted from capitalization under this paragraph (e).

(5) *Special temporary rule for citrus plants lost by reason of casualty.* Section 263A(d)(2)(A) provides that if plants bearing an edible crop for human consumption were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States). The rules of this paragraph (e)(5) apply to certain costs that are paid or incurred after

December 22, 2017, and on or before December 22, 2027, to replant citrus plants after the loss or damage of citrus plants. Notwithstanding paragraph (e)(2) of this section, in the case of replanting citrus plants after the loss or damage of citrus plants by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner described in section 263A(d)(2)(A) if—

(i) The owner described in section 263A(d)(2)(A) has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which such amounts were paid or incurred and the taxpayer holds any part of the remaining equity interest; or

(ii) The taxpayer acquired the entirety of the equity interest in the land of that owner described in section 263A(d)(2)(A) and on which land the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

(f) *Change in method of accounting.* Except as provided in paragraphs (d)(5) and (6) of this section, any change in a taxpayer's method of accounting necessary to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and §1.446–1 through 1.446–7 and §1.481–1 through §1.481–3 apply.

(g) *Applicability dates*—(1) *In general.* In the case of property that is not inventory in the hands of the taxpayer, this section is applicable to costs incurred after August 21, 2000 in taxable years ending after August 21, 2000. In the case of inventory property, this section is applicable to taxable years beginning after August 21, 2000.

(2) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).* Paragraphs (a)(3), (d)(5), (d)(6), and (e)(5) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

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§ 1.263A–5 Exception for qualified creative expenses incurred by certain free-lance authors, photographers, and artists. [Reserved]

§ 1.263A–6 Rules for foreign persons. [Reserved]

§ 1.263A–7 Changing a method of accounting under section 263A.

(a) *Introduction*—(1) *Purpose.* These regulations provide guidance to taxpayers changing their methods of accounting for costs subject to section 263A. The principal purpose of these regulations is to provide guidance regarding how taxpayers are to revalue property on hand at the beginning of the taxable year in which they change their method of accounting for costs subject to section 263A. Paragraph (c) of this section provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Paragraph (d) of this section provides guidance regarding how non-inventory property should be revalued in the year of change.

(2) *Taxpayers that adopt a method of accounting under section 263A.* Taxpayers may adopt a method of accounting for costs subject to section 263A in the first taxable year in which they engage in resale or production activities. For purposes of this section, the adoption of a method of accounting has the same meaning as provided in §1.446–1(e)(1). Taxpayers are not subject to the provisions of these regulations to the extent they adopt, as opposed to change, a method of accounting.

(3) *Taxpayers that change a method of accounting under section 263A.* Taxpayers changing their method of accounting for costs subject to section 263A are subject to the revaluation and other provisions of this section. Taxpayers subject to these regulations include, but are not limited to—

(i) For taxable years beginning after December 31, 2017, resellers of real or personal property or producers of real or tangible personal property whose average annual gross receipts for the immediately preceding 3-taxable-year period, or lesser period if the taxpayer was not in existence for the three preceding taxable years, annualized as required, exceed the gross receipts test of section 448(c) and the accompanying regulations where the taxpayer was not subject to section 263A in the prior taxable year;

(ii) Resellers of real or personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A;

(iii) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A; and

(iv) Resellers and producers that desire to change from one permissible method of accounting for costs subject to section 263A to another permissible method.

(4) *Applicability dates*—(i) *In general.*The provisions of this section are effective for taxable years beginning on or after August 5, 1997. For taxable years beginning before August 5, 1997, the rules of §1.263A–7T contained in the 26 CFR part 1 edition revised as of April 1, 1997, as modified by other administrative guidance, will apply.

(ii) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115–97).* Paragraph (a)(3)(i) of this section applies to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (a)(4)(ii), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

(5) *Definition of change in method of accounting.* For purposes of this section, a change in method of accounting has the same meaning as provided in §1.446–1(e)(2)(ii). Changes in method of accounting for costs subject to section 263A include changes to methods required or permitted by section 263A and the regulations thereunder. Changes in method of accounting may be described in the preceding sentence irrespective of whether the taxpayer's previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized under section 263A and the regulations thereunder, and irrespective of whether the taxpayer's previous method of accounting was a permissible method under the law in effect when the method was being used. However, changes in method of accounting for costs subject to section 263A do not include changes relating to factors other than those described therein. For example, a change in method of accounting for costs subject to section 263A does not include a change from one inventory identification method to another inventory identification method, such as a change from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, or vice versa, or a change from one inventory valuation method to another inventory valuation method under section 471, such as a change from valuing inventory at cost to valuing the inventory at cost or market, whichever is lower, or vice versa. In addition, a change in method of accounting for costs subject to section 263A does not include a change within the LIFO inventory method, such as a change from the double extension method to the link-chain method, or a change in the method used for determining the number of pools. Further, a change from the modified resale method set forth in Notice 89–67 (1989–1 C.B. 723), see §601.601(d)(2) of this chapter, to the simplified resale method set forth in §1.263A–3(d) is not a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is therefore not subject to the provisions of this section. However, a change from the simplified resale method set forth in former §1.263A–1T(d)(4) to the simplified resale method set forth in §1.263A–3(d) is a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is subject to the provisions of this section.

(b) *Rules applicable to a change in method of accounting*—(1) *General rules.* All changes in method of accounting for costs subject to section 263A are subject to the rules and procedures provided by the Code, regulations, and administrative procedures applicable to such changes. The Internal Revenue Service has issued specific revenue procedures that govern certain accounting method changes for costs subject to section 263A. Where a specific revenue procedure is not applicable, changes in method of accounting for costs subject to section 263A are subject to the same rules and procedures that govern other accounting method changes. See Revenue Procedure 2015–13 (2015–5 IRB 419) and §601.601(d)(2) of this chapter.

(2) *Special rules*—(i) *Ordering rules when multiple changes in method of accounting occur in the year of change*—(A) *In general.* A change in method of accounting for costs subject to section 263A is generally deemed to occur (including the computation of the adjustment under section 481(a)) before any other change in method of accounting is deemed to occur for that same taxable year.

(B) *Exceptions to the general ordering rule*—(*1*) *Change from the LIFO inventory method.* In the case of a taxpayer that is discontinuing its use of the LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the LIFO method may be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481 (a)) under section 263A is made.

(*2*) *Change from the specific goods LIFO inventory method.* In the case of a taxpayer that is changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the specific goods LIFO inventory method may be made before the change in method of accounting under section 263A is made.

(*3*) *Change in overall method of accounting.* In the case of a taxpayer that is changing its overall method of accounting from the cash receipts and disbursements method to an accrual method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the taxpayer must change to an accrual method for capitalizable costs (see §1.263A–1(c)(2)(ii)) before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(*4*) *Change in method of accounting for depreciation.* In the case of a taxpayer that is changing its method of accounting for depreciation in the same taxable year it is changing its method of accounting for costs subject to section 263A and any portion of the depreciation is subject to section 263A, the change in method of accounting for depreciation must be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(ii) *Adjustment required by section 481(a).* In the case of any taxpayer required or permitted to change its method of accounting for any taxable year under section 263A and the regulations thereunder, the change will be treated as initiated by the taxpayer for purposes of the adjustment required by section 481(a). The taxpayer must take the net section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for example, see Revenue Procedure 2015–13, 2015–5 IRB 419 (or successor) (also see §601.601(d)(2) of this chapter)). This paragraph applies to taxable years ending on or after June 16, 2004.

(iii) *Base year*—(A) *Need for a new base year.* Certain dollar-value LIFO taxpayers (whether using double extension or link-chain) must establish a new base year when they revalue their inventories under section 263A.

(*1*) *Facts and circumstances revaluation method used.* A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(*2*) *3-year average method used*—(*i*) *Simplified method not used.* A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method or the simplified resale method to revalue its inventory is required to establish a new base year.

(*ii*) *Simplified method used*. A dollar-value LIFO taxpayer using the 3-year average method and the simplified production method, the modified simplified production method, or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

(B) *Computing a new base year*. For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years. However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

(c) *Inventory*—(1) *Need for adjustments*. When a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by section 481(a). The adjustments required by section 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale. See paragraph (d) of this section in regard to the adjustments required by section 481(a) that relate to non-inventory property.

(2) *Revaluing beginning inventory*—(i) *In general*. If a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder apply to all inventory costs accumulated in prior years. The necessity to revalue beginning inventory as if these capitalization rules had been in effect for all prior years includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in §1.471–11(e), regardless of whether a taxpayer employed a cut-off method under those regulations. The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under section 481(a).

(ii) *Methods to revalue inventory*. There are three methods available to revalue inventory. The first method, the facts and circumstances revaluation method, may be used by all taxpayers. Under this method, a taxpayer determines the direct and indirect costs that must be assigned to each item of inventory based on all the facts and circumstances. This method is described in paragraph (c)(2)(iii) of this section. The second method, the weighted average method, is available only in certain situations to taxpayers using the FIFO inventory method or the specific goods LIFO inventory method. This method is described in paragraph (c)(2)(iv) of this section. The third method, the 3-year average method, is available to all taxpayers using the dollar-value LIFO inventory method of accounting. This method is described in paragraph (c)(2)(v) of this section. The weighted average method and the 3-year average method revalue inventory through processes of estimation and extrapolation, rather than based on the facts and circumstances of a particular year's data. All three methods are available regardless of whether the taxpayer elects to use a simplified method to capitalize costs under section 263A.

(iii) *Facts and circumstances revaluation method*—(A) *In general*. Under the facts and circumstances revaluation method, a taxpayer generally is required to revalue inventories by applying the capitalization rules of section

263A and the regulations thereunder to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986 (Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. (Vol. 1)). Thus, for example, with respect to any prior year that is relevant in determining the total amount of the revalued balance as of the beginning of the year of change, the taxpayer must analyze the production and resale data for that particular year and apply the rules and principles of section 263A and the regulations thereunder to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation method, a taxpayer may utilize reasonable estimates and procedures in valuing inventory costs if—

(*1*) The taxpayer lacks, and is not able to reconstruct from its books and records, actual financial and accounting data which is required to apply the capitalization rules of section 263A and the regulations thereunder to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(*2*) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer's former method) of the items or costs for the period in question.

(B) *Exception.* A taxpayer that is not able to comply with the requirement of paragraph (c)(2)(iii)(A)(2) of this section because of the existence of a significant amount of costs that would require the use of estimates and procedures must revalue its inventories under the procedures provided in paragraph (c)(2) (iv) or (v) of this section.

(C) *Estimates and procedures allowed.* The estimates and procedures of this paragraph (c)(2)(iii) include—

(*1*) The use of available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years; and

(*2*) The use of available information with respect to comparable items of inventory produced or acquired during the same year in order to estimate the costs associated with other items of inventory.

(D) *Use by dollar-value LIFO taxpayers.* Generally, a dollar-value LIFO taxpayer must recompute its LIFO inventory for each taxable year that the LIFO inventory method was used.

(E) *Examples.* The provisions of this paragraph (c)(2)(iii) are illustrated by the following three examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in all three examples is 1997. The examples read as follows:

Example 1. Taxpayer X lacks information for the years 1993 and earlier, regarding the amount of costs incurred in transporting finished goods from X's factory to X's warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1994 and subsequent years, these transportation and storage costs constitute 4 percent of the total costs of comparable goods under X's method of accounting for such years. Under this paragraph (c)(2)(iii), X may assume that transportation and storage costs for the years 1993 and earlier constitute 4 percent of the total costs of such goods.

Example 2. Assume the same facts as in *Example 1*, except that for the year 1993 and earlier, X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1994 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1994 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example—

(i) Increasing the percentage of costs that are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or

(ii) Taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1993 and prior periods.

Example 3. Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under section 263A and the regulations thereunder, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iv) *Weighted average method*—(A) *In general*. A taxpayer using the FIFO method or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (c)(2)(iv) to estimate the change in the amount of costs that must be allocated to inventories for prior years. The weighted average method under this paragraph (c)(2)(iv) is only available to a taxpayer that lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method provided for in paragraph (c)(2)(iii) of this section. Moreover, a taxpayer that qualifies for the use of the weighted average method under this paragraph (c)(2)(iv) must utilize such method only with respect to items or costs for which it lacks sufficient information to revalue under the facts and circumstances revaluation method. Particular items or costs must be revalued under the facts and circumstances revaluation method if sufficient information exists to make such a revaluation. If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (c)(2)(iv) (for example, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method, to whatever extent is necessary to allow the taxpayer to apply the weighted average method.

(B) *Weighted average method for FIFO taxpayers*—(*1*) *In general*. This paragraph (c)(2)(iv)(B) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under section 263A and the regulations thereunder must be revalued by using the weighted average percentage increase or decrease with respect to such item for the earliest subsequent taxable year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item must be revalued by using the weighted average percentage increase or decrease with respect to all reasonably comparable items in the taxpayer's inventory for the same year or the earliest subsequent taxable year for which sufficient data is available.

(*2*) *Example*. The provisions of this paragraph (c)(2)(iv)(B) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. Taxpayer A manufactures bolts and uses the FIFO method to identify inventories. Under A's former method, A did not capitalize all of the costs required to be capitalized under section 263A. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1994. The revaluation of the costs of Bolt A under this section for bolts produced in 1994 results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of Bolt A, however, is attributable to 1993. A does not have sufficient data for revaluation of the 1993 cost for Bolt A. With respect to Bolt A, A may apply the 20 percent increase determined for 1994 to the 1993 production as an acceptable estimate. Bolt B was last produced in 1992 and no data exists that would allow revaluation of the inventory cost of Bolt B. The inventories of all other bolts for which information is available are attributable to 1994 and 1995. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1994 production. With respect to Bolt B, the overall 15 percent increase for A's inventory for 1994 may be used in revaluing the cost of Bolt B.

(C) *Weighted average method for specific goods LIFO taxpayers*—(*1*) *In general*. This paragraph (c)(2)(iv)(C) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods method of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase or decrease in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good that lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase or decrease is to be determined using all other inventory items revalued by the taxpayer in the same specific goods grouping. This percentage increase or decrease is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a specific goods grouping, then the weighted average increase or decrease of substantially similar items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayers in §1.472–8(b)(3)) must be applied in the revaluation of the items in such grouping. If insufficient data exists with respect to all the items in a specific goods grouping and to all items that are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer's inventory must be applied in revaluing items for which data is lacking.

(*2*) *Example*. The provisions of this paragraph (c)(2)(iv)(C) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer M is a manufacturer that produces two different parts. Under M's former method, M did not capitalize all of the costs required to be capitalized under section 263A. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M's records show the following at the end of 1996 under the specific goods LIFO inventory method:

LIFO Product and layer	Number	Cost	Carrying values
Product #1:			
1993	150	$5.00	$750
1994	100	6.00	600
1995	100	6.50	650
1996	50	7.00	350
			$2,350
Product #2:			
1993	200	$4.00	$800
1994	200	4.50	900
1995	100	5.00	500
1996	100	6.00	600
			2,800
Total carrying value of Products #1 and #2 under M's former method			5,150

(ii) M has sufficient data to revalue the unit costs of Product #1 using its new method for 1994, 1995 and 1996. These costs are: $7.00 in 1994, $7.75 in 1995, and $9.00 in 1996. This data for Product #1 results in a weighted average percentage change of 20.31 percent ((100 × ($7.00 − $6.00)) + (100 × ($7.75 − $6.50)) + (50 × ($9.00 − $7.00)) divided by (100 × $6.00) + (100 × $6.50) + (50 × $7.00)]. M has sufficient data to revalue the unit costs of Product #2 only in 1995 and 1996. These costs are: $6.00 in 1995 and $7.00 in 1996. This data for Product #2 results in a weighted average percentage change of 18.18 percent [(100 × ($6.00 − $5.00)) + (100 × ($7.00 − $6.00)) divided by (100 × $5.00) + (100 × $6.00)].

(iii) M can estimate its revalued costs for Product #1 for 1993 by applying the weighted average increase computed for Product #1 (20.31 percent) to the unit costs originally carried on M's records for 1993 under M's former method. The estimated revalued unit cost of Product #1 would be $6.02 ($5.00 × 1.2031). M estimates its revalued costs for

Product #2 for 1993 and 1994 in a similar fashion. M applies the weighted average increase determined for Product #2 (18.18 percent) to the unit costs of $4.00 and $4.50 for 1993 and 1994 respectively. The revalued unit costs of Product #2 are $4.73 for 1993 ($4.00 × 1.1818) and $5.32 for 1994 ($4.50 × 1.1818).

(iv) M's inventory would be revalued as follows:

LIFO product and layer	Number	Cost	Carrying values
Product #1:			
1993	150	$6.02	$903
1994	100	7.00	700
1995	100	7.75	775
1996	50	9.00	450
			$2,828
Product #2:			
1993	200	4.73	946
1994	200	5.32	1,064
1995	100	6.00	600
1996	100	7.00	700
			3,310
Total value of Products #1 and #2 as revalued under M's new method			6,138
Total amount of adjustment required under section 481(a) [$6,138 − $5,150]			988

(D) *Adjustments to inventory costs from prior years.* For special rules applicable when a revaluation using the weighted average method includes costs not incurred in prior years, see paragraph (c)(2)(v)(E) of this section.

(v) *3-year average method*—(A) *In general.* A taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (c)(2)(v). The 3-year average method is based on the average percentage change (the 3-year revaluation factor) in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to any dollar-value taxpayer that complies with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts that do not constitute a separate trade or business. Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See, paragraph (b)(2)(iii)(A)(*2*)(*i*) of this section. However, a dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year. See, paragraph (b)(2)(iii)(A)(*2*)(*ii*) of this section. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (for example, the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(iii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) *Consecutive year requirement.* Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease only if the additional years are consecutive to and prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO inventory method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the three years consecutive to the year of change, that is, 1994 through 1996, may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) *Example.* The provisions of this paragraph (c)(2)(v) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer G, a calendar year taxpayer, is a reseller that is required to change its method of accounting under section 263A. G will not use either the simplified production method or the simplified resale method. G adopted the dollar-value LIFO inventory method in 1991, using a single pool and the double extension method. G's beginning LIFO inventory as of January 1, 1997, computed using its former method, for the year of change is as follows:

	Base year costs	Index	LIFO carrying value
Base layer	$14,000	1.00	$14,000
1991 layer	4,000	1.20	4,800
1992 layer	5,000	1.30	6,500
1993 layer	2,000	1.35	2,700
1994 layer	0	1.40	0
1995 layer	4,000	1.50	6,000
1996 layer	5,000	1.60	8,000
Total	34,000		42,000

(ii) G is able to recompute total inventoriable costs incurred under its new method for the three preceding taxable years as follows:

	Current cost as recorded (former method)	Current cost as adjusted (new method)	Percentage change
1994	$35,000	$45,150	.29
1995	43,500	54,375	.25
1996	54,400	70,720	.30
Total	132,900	170,245	.28

(iii) Applying the average revaluation factor of .28 to each layer, G's inventory is restated as follows:

	Restated base year costs	Index	Restated LIFO carrying value
Base layer	$17,920	1.00	$17,920
1991 layer	5,120	1.20	6,144
1992 layer	6,400	1.30	8,320
1993 layer	2,560	1.35	3,456
1994 layer	0	1.40	0
1995 layer	5,120	1.50	7,680
1996 layer	6,400	1.60	10,240
Total	43,520		53,760

(iv) The adjustment required by section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of G's inventory valued using its former method ($42,000). Alternatively, the adjustment required by section 481(a) may be computed by the difference between—

(A) The revalued costs of the taxpayer's inventory under its new method ($53,760), and

(B) The costs of the taxpayer's inventory using its former method ($42,000).

(v) In addition, the inventory as of the first day of the year of change (January 1, 1997) becomes the new base year cost for purposes of determining the LIFO index in future years. See, paragraphs (b)(2)(iii)(A)(*2*)(*i*) and (b)(2)(iii)(B) of this section. This requires that layers in years prior to the base year be restated in terms of the new base year index. The current year cost of G's inventory, as adjusted, is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520), as follows:

	Restated base year costs	Restated index	Restated LIFO carrying value
Old base layer	$29,120	.615	$17,920
1991 layer	8,320	.738	6,144
1992 layer	10,400	.80	8,320
1993 layer	4,160	.831	3,456
1994 layer	0		0
1995 layer	8,320	.923	7,680
1996 layer	10,400	.985	10,240
Total	70,720		53,760

(D) *Short taxable years.* A short taxable year is treated as a full 12 months.

(E) *Adjustments to inventory costs from prior years*—(*1*) *General rule.* (*i*) The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method, as described in paragraph (c)(2)(v) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted under the restatement adjustment procedure, as described in paragraph (c)(2)(v)(F) of this section. The determination that a cost could not have affected a prior year must be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (revaluation years) was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply because the cost varies in amount from year to year or the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (c)(2)(v)(F) of this section is not available in a prior year with respect to a particular cost if the same type of cost was incurred both in the revaluation years and in such prior year, although the amount of such cost and the name or description thereof may vary.

(*ii*) The provisions of this paragraph (c)(2)(v)(E) are also applicable to taxpayers using the weighted average method in revaluing inventories under paragraph (c)(2)(iv) of this section. Thus, to the extent a taxpayer can demonstrate that costs that contributed to the determination of the restatement of a particular year or item could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (c)(2)(v)(E) fully apply to a taxpayer using the weighted average method to revalue inventories.

(*2*) *Examples of costs eligible for restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(E) are illustrated by the following four examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the four examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that introduced a defined benefit pension plan in 1994, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to resale activities. A determines the revaluation factor based on data available for the years 1994 through 1996, for which the pension plan was in existence. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1994.

Example 2. Assume the same facts as in *Example 1,* except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1994. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

Example 3. Taxpayer C is a manufacturer that established a security department in 1995 to patrol and safeguard its production and warehouse areas used in C's trade or business. Prior to 1995, C had not been required to utilize security personnel in its trade or business; C established the security department in 1995 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1995.

Example 4. Taxpayer D is a reseller that established a payroll department in 1995 to process the company's weekly payroll. In the years 1991 through 1994, D engaged the services of an outside vendor to process the company's payroll. Prior to 1991, D's payroll processing was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1995 and subsequent years, although these costs were designated by a different name or description.

(F) *Restatement adjustment procedure*—(*1*) *In general.* (*i*) This paragraph (c)(2)(v)(F) provides a restatement adjustment procedure whereunder a taxpayer may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(*ii*) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer must determine the particular items of cost that are eligible for the restatement adjustment with respect to such prior year. The taxpayer must then recompute, using reasonable estimates and procedures, the total inventoriable costs that would have been incurred for each revaluation year under the taxpayer's former method and the taxpayer's new method by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(*iii*) The taxpayer must then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in paragraph (c)(2)(v)(F)(*1*)(*ii*) of this section. The percentage change must be determined by calculating the ratio of the revised total of the inventoriable costs for such revaluation year under the taxpayer's new method to the revised total of the inventoriable costs for such revaluation year under the taxpayer's former method.

(*iv*) An average of the resulting percentage change for all revaluation years is then calculated, and the resulting average is applied to the prior year in issue.

(*2*) *Examples of restatement adjustment procedure*. The provisions of this paragraph (c)(2)(v)(F) are illustrated by the following two examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the two examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan that was introduced in 1994, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (c)(2)(v)(C) of this section. Thus, for example, with respect to the year 1994, the total inventoriable costs under A's former method is $35,000, the total inventoriable costs under A's new method is $45,150, and the percentage change is .29. Under the method of accounting used by A during 1994 (the former method), none of the pension costs were included as inventoriable costs. Thus, under the restatement adjustment procedure, the total inventoriable cost under A's former method would remain at $35,000 if the pension plan had not been in existence. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .20 ([$42,000–$35,000]/$35,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur.

Example 2. Assume the same facts as in *Example 1*, except that a portion of the pension costs were included as inventoriable costs under the method used by A during 1994 (the former method). Under the restatement adjustment procedure, A determines that the total inventoriable costs for 1994 under the former method, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .24 ([$42,000–$34,000]/$34,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence.

(3) *Intercompany items*—(i) *Revaluing intercompany transactions*. Pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted, had the cost of goods sold for that inventory property been determined under the taxpayer's new method. The requirement of the preceding sentence applies with respect to both inventory produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of this paragraph (c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See § 1.1502–13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under this paragraph (c)(3). Moreover, the requirements of this paragraph (c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See § 1.1502–13 for the definition of intercompany transaction.

(ii) *Example*. The provisions of this paragraph (c)(3) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Assume that S, a member of a consolidated group filing its federal income tax return on a calendar year, manufactures and sells inventory property to B, a member of the same consolidated group, in 1996. The sale between S and B is an intercompany transaction as defined under §1.1502–13(b)(1). The gain from the intercompany transaction is an intercompany item to S under §1.1502–13(b)(2). As of the beginning of the year of change in method of accounting (January 1, 1997), the inventory property is still held by B based on the particular inventory method of accounting used by B for federal income tax purposes (for example, the LIFO or FIFO inventory method). The property was sold by S to B in 1996 for $150; the cost of goods sold with respect to the property under the method in effect at the time the inventory was produced was $100, resulting in an intercompany item of $50 to S under §1.1502–13. As of January 1, 1997, S still has an intercompany item of $50.

(ii) S is required to revalue the amount of its intercompany item to an amount equal to what the intercompany item would have been had the cost of goods sold for that inventory property been determined under S's new method. Assume that the cost of the inventory under this method would have been $110, had the method applied to S's manufacture of the property in 1996. Thus, S is required to revalue the amount of its intercompany item to $40 (that is, $150 less $110), necessitating a negative adjustment to the intercompany item of $10. Moreover, S is required to increase its adjustment under section 481(a) by $10 in order to prevent the omission of such amount by virtue of the decrease in the intercompany item.

(iii) *Availability of revaluation methods.* In revaluing the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in revaluing inventory under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in this paragraph (c).

(4) *Anti-abuse rule*—(i) *In general.* Section 263A(i)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of section 263A and the regulations thereunder. One way in which the application of section 263A and the regulations thereunder would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required or permitted under section 263A and the regulations thereunder.

(ii) *Deemed avoidance of this section*—(A) *Scope.* For purposes of this paragraph (c), the avoidance of the application of section 263A and the regulations thereunder will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(*1*) On or before the beginning of the transferor's taxable year beginning in 1987; and

(*2*) After September 18, 1986.

(B) *General rule.* Any transaction described in paragraph (c)(4)(ii)(A) of this section will be treated in the following manner:

(*1*) Notwithstanding any provision to the contrary (for example, section 381), the transferee corporation is required to revalue the inventories acquired from the transferor under the provisions of this paragraph (c) relating to the change in method of accounting and the adjustment required by section 481(a), as if the inventories had never been transferred and were still in the hands of the transferor; and

(*2*) Absent an election as described in paragraph (c)(4)(iii) of this section, the transferee must account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee's LIFO layer(s).

(iii) *Election to use transferor's LIFO layers.* If a transferee described in paragraph (c)(4)(ii) of this section so elects, the transferee may account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee must account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election is to be made on a statement attached to the timely filed federal income tax return of the transferee for the first taxable year for which section 263A and the regulations thereunder applies to the transferee.

(iv) *Tax avoidance intent not required.* The provisions of paragraph (c)(4)(ii) of this section will apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) *Related corporation.* For purposes of this paragraph (c)(4), a taxpayer is related to a corporation if—

(A) the relationship between such persons is described in section 267(b)(1), or

(B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(d) *Non-inventory property*—(1) *Need for adjustments.* A taxpayer that changes its method of accounting for costs subject to section 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change as set forth in paragraph (d)(2) of this section, and compute an adjustment under section 481(a). The adjustment under section 481(a) will equal the difference between the adjusted basis of the property as revalued using the taxpayer's new method and the adjusted basis of the property as originally valued using the taxpayer's former method.

(2) *Revaluing property.* A taxpayer must revalue its non-inventory property as of the beginning of the year of change in method of accounting. The facts and circumstances revaluation method of paragraph (c)(2)(iii) of this section must be used to revalue this property. In revaluing non-inventory property, however, the only additional section 263A costs that must be taken into account are those additional section 263A costs incurred after the later of December 31, 1986, or the date the taxpayer first becomes subject to section 263A, in taxable years ending after that date. See §1.263A–1(d)(3) for the definition of additional section 263A costs.

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§ 1.263A–8 Requirement to capitalize interest.

(a) *In general*—(1) *General rule.* Capitalization of interest under the avoided cost method described in §1.263A–9 is required with respect to the production of designated property described in paragraph (b) of this section. However, a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test of section 448(c) for the taxable year is not required to capitalize costs, including interest, under section 263A. See §1.263A–1(j).

(2) *Treatment of interest required to be capitalized.* In general, interest that is capitalized under this section is treated as a cost of the designated property and is recovered in accordance with §1.263A–1(c)(4). Interest capitalized by reason of assets used to produce designated property (within the meaning of §1.263A–11(d)) is added to the basis of the designated property rather than the bases of the assets used to produce the designated property. Interest capitalized with respect to designated property that includes both components subject to an allowance for depreciation or depletion and components not subject to an allowance for depreciation or depletion is ratably allocated among, and is treated as a cost of, components that are subject to an allowance for depreciation or depletion.

(3) *Methods of accounting under section 263A(f).* Except as otherwise provided, methods of accounting and other computations under §§1.263A–8 through 1.263A–15 are applied on a taxpayer, as opposed to a separate and distinct trade or business, basis.

(4) *Special definitions*—(i) *Related person.* Except as otherwise provided, for purposes of §§1.263A–8 through 1.263A–

15, a person is related to a taxpayer if their relationship is described in section 267(b) or 707(b).

(ii) *Placed in service.* For purposes of §§ 1.263A–8 through 1.263A–15, *placed in service* has the same meaning as set forth in § 1.46–3(d).

(b) *Designated property*—(1) *In general.* Except as provided in paragraphs (b)(3) and (b)(4) of this section, *designated property* means any property that is produced and that is either:

(i) Real property; or

(ii) Tangible personal property (as defined in § 1.263A–2(a)(2)) which meets any of the following criteria:

(A) Property with a class life of 20 years or more under section 168 (long-lived property), but only if the property is not property described in section 1221(l) in the hands of the taxpayer or a related person,

(B) Property with an estimated production period (as defined in § 1.263A–12) exceeding 2 years (2-year property), or

(C) Property with an estimated production period exceeding 1 year and an estimated cost of production exceeding $1,000,000 (1-year property).

(2) *Special rules*—(i) *Application of thresholds.* The thresholds described in paragraphs (b)(l)(ii)(A), (B), and (C) of this section are applied separately for each unit of property (as defined in § 1.263A–10).

(ii) *Relevant activities and costs.* For purposes of determining whether property is designated property, all activities and costs are taken into account if they are performed or incurred by, or for, the taxpayer or any related persons and they directly benefit or are incurred by reason of the production of the property.

(iii) *Production period and cost of production.* For purposes of applying the classification thresholds under paragraphs (b)(l)(ii) (B) and (C) of this section to a unit of property, the taxpayer is required, at the beginning of the production period, to reasonably estimate the production period and the total cost of production for the unit of property. The taxpayer must maintain contemporaneous written records supporting the estimates and classification. If the estimates are reasonable based on the facts in existence at the beginning of the production period, the taxpayer's classification of the property is not modified in subsequent periods, even if the actual length of the production period or the actual cost of production differs from the estimates. To be considered reasonable, estimates of the production period and the total cost of production must include anticipated expense and time for delay, rework, change orders, and technological, design or other problems. To the extent that several distinct activities related to the production of the property are expected to occur simultaneously, the period during which these distinct activities occur is not counted more than once. The bases of assets used to produce a unit of property (within the meaning of § 1.263A–11(d)) and any interest that would be required to be capitalized if a unit of property were designated property are disregarded in making estimates of the total cost of production for purposes of this paragraph (b)(2)(iii).

(3) *Excluded property.* Designated property does not include:

(i) Timber and evergreen trees that are more than 6 years old when severed from the roots, or

(ii) Property produced by the taxpayer for use by the taxpayer other than in a trade or business or an activity conducted for profit.

(4) *De minimis rule*—(i) *In general.* Designated property does not include property for which—

(A) The production period does not exceed 90 days; and

(B) The total production expenditures do not exceed $1,000,000 divided by the number of days in the production period.

(ii) *Determination of total production expenditures.* For purposes of determining whether the condition of paragraph (b)(4)(i)(B) of this section is met with respect to property, the cost of land, the adjusted basis of property used to produce property, and interest that would be capitalized with respect to property if it were designated property are excluded from total production expenditures.

(c) *Definition of real property*—(1) *In general.* Real property includes land, unsevered natural products of land, buildings, and inherently permanent structures. Any interest in real property of a type described in this paragraph (c), including fee ownership, co-ownership, a leasehold, an option, or a similar interest is real property under this section. Real property includes the structural components of both buildings and inherently permanent structures, such as walls, partitions, doors, wiring, plumbing, central air conditioning and heating systems, pipes and ducts, elevators and escalators, and other similar property. Tenant improvements to a building that are inherently permanent or otherwise classified as real property within the meaning of this paragraph (c)(1) are real property under this section. However, property produced for sale that is not real property in the hands of the taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer (e.g., bricks, nails, paint, and windowpanes).

(2) *Unsevered natural products of land.* Unsevered natural products of land include growing crops and plants, mines, wells, and other natural deposits. Growing crops and plants, however, are real property only if the preproductive period of the crop or plant exceeds 2 years.

(3) *Inherently permanent structures.* Inherently permanent structures include property that is affixed to real property and that will ordinarily remain affixed for an indefinite period of time, such as swimming pools, roads, bridges, tunnels, paved parking areas and other pavements, special foundations, wharves and docks, fences, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, permanently installed telecommunications cables, broadcasting towers, oil and gas pipelines, derricks and storage equipment, grain storage bins and silos. For purposes of this section, affixation to real property may be accomplished by weight alone. Property may constitute an inherently permanent structure even though it is not classified as a building for purposes of former section 48(a)(1)(B) and §1.48–1. Any property not othewise described in this paragraph (c)(3) that constitutes other tangible property under the principles of former section 48(a)(1)(B) and §1.48–1(d) is treated for the purposes of this section as an inherently permanent structure.

(4) *Machinery*—(i) *Treatment.* A structure that is property in the nature of machinery or is essentially an item of machinery or equipment is not an inherently permanent structure and is not real property. In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the property in the nature of machinery is real property.

(ii) *Certain factors not determinative.* A structure may be an inherently permanent structure, and not property in the nature of machinery or essentially an item of machinery, even if the structure is necessary to operate or use, supports, or is otherwise associated with, machinery.

(d) *Production*—(1) *Definition of produce. Produce* is defined as provided in section 263A(g) and §1.263A–2(a)(1)(i).

(2) *Property produced under a contract*—(i) *Customer.* A taxpayer is treated as producing any property that is produced for the taxpayer (the customer) by another party (the contractor) under a contract with the taxpayer or an intermediary. Property produced under a contract is designated property to the customer if it is real property or tangible personal property that satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. If property produced under a contract will become part of a unit of designated property produced by the customer in the customer's hands, the property produced under the contract is designated property to the customer.

(ii) *Contractor.* Property produced under a contract is designated property to the contractor if it is real property, 2-year property, or 1-year property and the property produced under the contract is not excluded by reason of paragraph (d)(2)(v) of this section.

(iii) *Definition of a contract.* For purposes of this paragraph (d)(2), *contract* has the same meaning as under §1.263A–2(a)(1)(ii)(B)(*2*).

(iv) *Determination of whether thresholds are satisfied.* In the case of tangible personal property produced under a contract, the customer and the contractor each determine under this paragraph (d)(2), whether the property satisfies the classification thresholds described in paragraph (b)(1)(ii) of this section. Thus, tangible personal property may be designated property with respect to either, or both, the customer and the contractor. The provisions of paragraph (b)(2)(iii) of this section are modified as set forth in this paragraph (d)(2)(iv) for purposes of determining whether tangible personal property produced under a contract is 2-year property or 1-year property.

(A) *Customer.* In determining a customer's estimated cost of production, the customer takes into account costs and payments that are reasonably expected to be incurred by the customer, but does not take into account costs incurred (or to be incurred) by an unrelated contractor. In determining the customer's estimated length of the production period, the production period is treated as beginning on the earlier of the date the contract is executed or the date that the customer's accumulated production expenditures for the unit are at least 5 percent of the customer's total estimated production expenditures for the unit. The customer, however, may elect to treat the production period as beginning on the date the sum of the accumulated production expenditures of the contractor (or contractors if more than one contractor is producing components for the unit of property) and of the customer are at least 5 percent of the customer's estimated production expenditures for the unit.

(B) *Contractor.* In determining a contractor's estimated cost of production, the contractor takes into account only the costs that are reasonably expected to be incurred by the contractor, without any reduction for payments from the customer. In determining the contractor's estimated length of the production period, the production period is treated as beginning on the date the contractor's accumulated production expenditures (without any reduction for payments from the customer) are at least 5 percent of the contractor's total estimated accumulated production expenditures.

(v) *Exclusion for property subject to long-term contract rules.* Property described in paragraph (b) of this section is designated property with respect to a contractor only if—

(A) The contract is not a long-term contract (within the meaning of section 460(f)); or

(B) The contract is a home construction contract (within the meaning of section 460(e)(6)(A)) with respect to which the requirements of section 460(e)(1)(B) (i) and (ii) are not met.

(3) *Improvements to existing property*—(i) *In general.* Any improvement to property described in §1.263(a)–1(b) constitutes the production of property. Generally, any improvement to designated property constitutes the production of designated property. An improvement is not treated as the production of designated property, however, if the de minimis exception described in paragraph (b)(4) of this section applies to the improvement. In addition, paragraph (d)(3)(iii) of this section provides an exception for certain improvements to tangible personal property. Incidental maintenance and repairs are not treated as improvements under this paragraph (d)(3). See §1.162–4.

(ii) *Real property.* The rehabilitation or preservation of a standing building, the clearing of raw land prior to sale, and the drilling of an oil well are activities constituting improvements to real property and, therefore, the production of designated property. Similarly, the demolition of a standing building generally constitutes an activity that is an improvement to real property and, therefore, the production of designated property. See the exceptions, however, in paragraphs (b)(3) and (b)(4) of this section.

(iii) *Tangible personal property.* If the taxpayer has treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property regardless of the remaining useful life of the improved property (or the improvement) and, except as provided in paragraph (b)(4) of this section, regardless of the estimated length of the production period or the estimated cost of the improvement. If the taxpayer has not treated a unit of tangible personal property as designated property under this section, an improvement to such property constitutes the production of designated property only if the improvement independently meets the classification thresholds described in paragraph (b)(1)(ii) of this section.

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§ 1.263A–9 The avoided cost method.

(a) *In general*—(1) *Description.* The avoided cost method described in this section must be used to calculate the amount of interest required to be capitalized under section 263A(f). Generally, any interest that the taxpayer theoretically would have avoided if accumulated production expenditures (as defined in § 1.263A–11) had been used to repay or reduce the taxpayer's outstanding debt must be capitalized under the avoided cost method. The application of the avoided cost method does not depend on whether the taxpayer actually would have used the amounts expended for production to repay or reduce debt. Instead, the avoided cost method is based on the assumption that debt of the taxpayer would have been repaid or reduced without regard to the taxpayer's subjective intentions or to restrictions (including legal, regulatory, contractual, or other restrictions) against repayment or use of the debt proceeds.

(2) *Overview*—(i) *In general.* For each unit of designated property (within the meaning of § 1.263A–8(b)), the avoided cost method requires the capitalization of—

(A) The traced debt amount under paragraph (b) of this section, and

(B) The excess expenditure amount under paragraph (c) of this section.

(ii) *Rules that apply in determining amounts.* The traced debt and excess expenditure amounts are determined for each taxable year or shorter computation period that includes the production period (as defined in § 1.263A–12) of a unit of designated property. Paragraph (d) of this section provides an election not to trace debt to specific units of designated property. Paragraph (f) of this section provides rules for selecting the computation period, for calculating averages, and for determining measurement dates within the computation period. Special rules are in paragraph (g) of this section.

(3) *Definitions of interest and incurred.* Except as provided in the case of certain expenses that are treated as a substitute for interest under paragraphs (c)(2)(iii) and (g)(2)(iv) of this section, *interest* refers to all amounts that are characterized as interest expense under any provision of the Code, including, for example, sections 482, 483, 1272, 1274, and 7872. *Incurred* refers to the amount of interest that is properly accruable during the period of time in question determined by taking into account the loan agreement and any applicable provisions of the Internal Revenue laws and regulations such as section 163, § 1.446–2, and sections 1271 through 1275.

(4) *Definition of eligible debt.* Except as provided in this paragraph (a)(4), *eligible debt* includes all outstanding debt (as evidenced by a contract, bond, debenture, note, certificate, or other evidence of indebtedness). Eligible debt does not include—

(i) Debt (or the portion thereof) bearing interest that is disallowed under a provision described in § 1.163–8T(m)(7)(ii);

(ii) Debt, such as accounts payable and other accrued items, that bears no interest, except to the extent that such debt is traced debt (as defined in paragraph (b)(2) of this section);

(iii) Debt that is borrowed directly or indirectly from a person related to the taxpayer and that bears a rate of interest that is less than the applicable Federal rate in effect under section 1274(d) on the date of issuance;

(iv) Debt (or the portion thereof) bearing personal interest within the meaning of section 163(h)(2);

(v) Debt (or the portion thereof) bearing qualified residence interest within the meaning of section 163(h)(3);

(vi) Debt incurred by an organization that is exempt from Federal income tax under section 501(a), except to the extent interest on such debt is directly attributable to an unrelated trade or business of the organization within the meaning of section 512;

(vii) Reserves, deferred tax liabilities, and similar items that are not treated as debt for Federal income tax purposes, regardless of the extent to which the taxpayer's applicable financial accounting or other regulatory reporting principles require or support treating these items as debt;

(viii) Federal, State, and local income tax liabilities, deferred tax liabilities under section 453A, and hypothetical tax liabilities under the look-back method of section 460(b) or similar provisions; and

(ix) A purchase money obligation given by the lessor to the lessee (or a party that is related to the lessee) in a sale and leaseback transaction involving an agreement qualifying as a lease under §5c.168(f)(8)-1 through §5c.168(f)(8)–11 of this chapter. *See* §5c.168(f)(8)–1(e) *Example (2)* of this chapter.

(b) *Traced debt amount*—(1) *General rule.* Interest must be capitalized with respect to a unit of designated property in an amount (the traced debt amount) equal to the total interest incurred on the traced debt during each measurement period (as defined in paragraph (f)(2)(ii) of this section) that ends on a measurement date described in paragraph (f)(2)(iii) of this section. See the example in paragraph (b)(3) of this section. If any interest incurred on the traced debt is not taken into account for the taxable year that includes the measurement period because of a deferral provision, see paragraph (g)(2) of this section for the time and manner for capitalizing and recovering that amount. This paragraph (b)(1) does not apply if the taxpayer elects under paragraph (d) of this section not to trace debt.

(2) *Identification and definition of traced debt.* On each measurement date described in paragraph (f)(2)(iii) of this section, the taxpayer must identify debt that is traced debt with respect to a unit of designated property. On each such date, traced debt with respect to a unit of designated property is the outstanding eligible debt (as defined in paragraph (a)(4) of this section) that is allocated, on that date, to accumulated production expenditures with respect to the unit of designated property under the rules of §1.163–8T. Traced debt also includes unpaid interest that has been capitalized with respect to such unit under paragraph (b)(1) of this section and that is included in accumulated production expenditures on the measurement date.

(3) *Example.* The provisions of paragraphs (b)(1) and (b)(2) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts a taxable year computation period and quarterly measurement dates. Production of unit A starts on January 14, 1995, and ends on June 16, 1995. On March 31, 1995 and on June 30, 1995, Corporation X has outstanding a $1,000,000 loan that is allocated under the rules of §1.163–8T to production expenditures with respect to unit A. During the period January 1, 1995, through June 30, 1995, Corporation X incurs $50,000 of interest related to the loan. Under paragraph (b)(1) of this section, the $50,000 of interest Corporation X incurs on the loan during the period January 1, 1995, through June 30, 1995, must be capitalized with respect to unit A.

(c) *Excess expenditure amount*—(1) *General rule.* If there are accumulated production expenditures in excess of traced debt with respect to a unit of designated property on any measurement date described in paragraph (f)(2)(iii) of this section, the taxpayer must, for the computation period that includes the measurement date, capitalize with respect to this unit the excess expenditure amount calculated under this paragraph (c)(1). However, if the sum of the excess expenditure amounts for all units of designated property of a taxpayer exceeds the total interest described in paragraph (c)(2) of this section, only a prorata amount (as determined under paragraph (c)(7) of this section) of such interest must be capitalized with respect to each unit. For each unit of designated property, the excess expenditure amount for a computation period equals the product of—

(i) The average excess expenditures (as determined under paragraph (c)(5)(ii) of this section) for the unit of designated property for that period, and

(ii) The weighted average interest rate (as determined under paragraph (c)(5)(iii) of this section) for that period.

(2) *Interest required to be capitalized.* With respect to an excess expenditure amount, interest incurred during the computation period is capitalized from the following sources and in the following sequence but not in excess of the excess expenditure amount for all units of designated property:

(i) Interest incurred on nontraced debt (as defined in paragraph (c)(5)(i) of this section);

(ii) Interest incurred on borrowings described in paragraph (a)(4)(iii) of this section (relating to certain borrowings from related persons); and

(iii) In the case of a partnership, guaranteed payments for the use of capital (within the meaning of section 707(c)) that would be deductible by the partnership if section 263A(f) did not apply.

(3) *Example.* The provisions of paragraph (c)(1) and (2) of this section are illustrated by the following example.

Example. (i) P, a partnership owned equally by Corporation A and Individual B, is engaged in the construction of an office building during 1995. Average excess expenditures for the office building for 1995 are $2,000,000. When P was formed, A and B agreed that A would be entitled to an annual guaranteed payment of $70,000 in exchange for A's capital contribution. The only borrowing of P, A, and B for 1995 is a loan to P from an unrelated lender of $1,000,000 (loan #1). The loan is nontraced debt and bears interest at an annual rate of 10 percent. Thus, P's weighted average interest rate (determined under paragraph (c)(5)(iii) of this section) is 10 percent and interest incurred during 1995 is $100,000.

(ii) In accordance with paragraph (c)(1) of this section, the excess expenditure amount is $200,000 ($2,000,000 × 10%). The interest capitalized under paragraph (c)(2) of this section is $170,000 ($100,000 of interest plus $70,000 of guaranteed payments).

(4) *Treatment of interest subject to a deferral provision.* If any interest described in paragraph (c)(2) of this section is not taken into account for the taxable year that includes the computation period because of a deferral provision described in paragraph (g)(1)(ii) of this section, paragraph (c)(2) of this section is first applied without regard to the amount of the deferred interest. After applying paragraph (c)(2) without regard to the deferred interest, if the amount of interest capitalized with respect to all units of designated property for the computation period is less than the amount that would have been capitalized if a deferral provision did not apply, see paragraph (g)(2) of this section for the time and manner for capitalizing and recovering the difference (the shortfall amount).

(5) *Definitions*—(i) *Nontraced debt*—(A) *Defined. Nontraced debt* means all eligible debt on a measurement date other than any debt that is treated as traced debt with respect to any unit of designated property on that measurement date. For example, nontraced debt includes eligible debt that is allocated to expenditures that are not capitalized under section 263A(a) (*e.g.*, expenditures deductible under section 174(a) or 263(c)). Similarly, even if eligible debt is allocated to a production expenditure for a unit of designated property, the debt is included in nontraced debt on measurement dates before the first or after the last measurement date for that unit of designated property. Thus, nontraced debt may include debt that was previously treated as traced debt or that will be treated as traced debt on a future measurement date.

(B) *Example.* The provisions of paragraph (c)(5)(i)(A) of this section are illustrated by the following example.

Example. In 1995, Corporation X begins, but does not complete, the construction of two office buildings that are separate units of designated property as defined in §1.263A–10 (Property D and Property E). At the beginning of 1995, X borrows $2,500,000 (the $2,500,000 loan), which will be used exclusively to finance production expenditures for Property D. Although interest is paid currently, the entire principal amount of the loan remains outstanding at the end of 1995. Corporation X also has outstanding during all of 1995 a long-term loan with a principal amount of $2,000,000 (the $2,000,000 loan). The proceeds of the $2,000,000 loan were used exclusively to finance the production of Property C, a unit of designated property that was completed in 1994. Under the rules of paragraph (b)(2) of this section, the portion of the $2,500,000 loan allocated to accumulated production expenditures for property D at each measurement date during 1995 is treated as traced debt for that measurement date. The excess, if any, of $2,500,000 over the amount treated as traced debt at each measurement date during 1995 is treated as nontraced debt for that measurement date, even though it is expected that the entire $2,500,000 will be treated as traced debt with respect to Property D on subsequent measurement dates as more of the proceeds of the loan are used to finance additional production expenditures. In addition, the entire principal amount of the $2,000,000 loan is treated as nontraced debt for 1995, even though it was treated as traced debt with respect to Property C in a previous period.

(ii) *Average excess expenditures*—(A) *General rule.* The average excess expenditures for a unit of designated property for a computation period are computed by—

(*1*) Determining the amount (if any) by which accumulated production expenditures exceed traced debt at each measurement date during the computation period; and

(*2*) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(B) *Example.* The provisions of paragraph (c)(5)(ii)(A) of this section are illustrated by the following example.

Example. Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. The production period for unit A begins on January 14, 1995, and ends on June 16, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of traced debt with respect to unit A. Accumulated production expenditures for unit A on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt for unit A on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000. Average excess expenditures for unit A during 1995 are therefore $250,000 ([$400,000 + $600,000 + $0 + $0] ÷ 4).

(iii) *Weighted average interest rate*—(A) *Determination of rate.* The weighted average interest rate for a computation period is determined by dividing interest incurred on nontraced debt during the period by average nontraced debt for the period.

(B) *Interest incurred on nontraced debt.* Interest incurred on nontraced debt during the computation period is equal to the total amount of interest incurred during the computation period on all eligible debt minus the amount of interest incurred during the computation period on traced debt. Thus, all interest incurred on nontraced debt during the computation period is included in the numerator of the weighted average interest rate, even if the underlying nontraced debt is repaid before the end of a measurement period and excluded from nontraced debt outstanding for measurement dates after repayment, in determining the denominator of the weighted average interest rate. However, see paragraph (g)(7) of this section for an election to treat eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding on that measurement date. See paragraph (a)(3) of this section for the definitions of interest and incurred.

(C) *Average nontraced debt.* The average nontraced debt for a computation period is computed by—

(*1*) Determining the amount of nontraced debt outstanding on each measurement date during the computation period; and

(*2*) Dividing the sum of these amounts by the number of measurement dates during the computation period.

(D) *Special rules if taxpayer has no nontraced debt or rate is contingent.* If the taxpayer does not have nontraced debt outstanding during the computation period, the weighted average interest rate for purposes of applying paragraphs (c)(1) and (c)(2) of this section is the highest applicable Federal rate in effect under section 1274(d) during the computation period. If interest is incurred at a rate that is contingent at the time the return for the year that includes the computation period is filed, the amount of interest is determined using the higher of the fixed rate of interest (if any) on the underlying debt or the applicable Federal rate in effect under section 1274(d) on the date of issuance.

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

Example 1. (i) W, a calendar year taxpayer, is engaged in the production of a unit of designated property during 1995. For purposes of applying the avoided cost method of this section, W uses the taxable year as the computation period. During 1995, W's only debt is a $1,000,000 loan bearing interest at a rate of 7 percent from Y, a person that is related to W. Assuming the applicable Federal rate in effect under section 1274(d) on the date of issuance of the loan is 10 percent, the loan is not eligible debt under paragraph (a)(4) of this section. However, even though W has no eligible debt, W incurs $70,000 ($1,000,000 × 7%) of interest during the computation period. This interest is described in paragraph (c)(2) of this section and must be capitalized under paragraph (c)(1) of this section to the extent it does not exceed W's excess expenditure amount for the unit of property.

(ii) W determines, under paragraph (c)(5)(ii) of this section, that average excess expenditures for the unit of property are $600,000. Assuming the highest applicable Federal rate in effect under section 1274(d) during the computation period is 10 percent, W uses 10 percent as the weighted average interest rate for purposes of determining the excess expenditure amount. See paragraph (c)(5)(iii)(D) of this section. In accordance with paragraph (c)(1) of this section, the excess expenditure amount is therefore $60,000. Because this amount does not exceed the total amount of interest described in paragraph (c)(2) of this section ($70,000), W is required to capitalize $60,000 of interest with respect to the unit of designated property for the 1995 computation period.

Example 2. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1955 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Production of unit A begins in 1994 and ends on June 30, 1995. On March 31, 1995, and on June 30, 1995, Corporation X has outstanding $1,000,000 of eligible debt (loan #1) that is allocated under the rules of § 1.163–8T to production expenditures for unit A. During each of the first two quarters of 1995, $30,000 of interest is incurred on loan #1. The loan is repaid on July 1, 1995. Throughout 1995, Corporation X also has outstanding $2,000,000 of eligible debt (loan #2) which is not allocated under the rules of § 1.163–8T to the production of unit A. During 1995, $200,000 of interest is incurred on this nontraced debt. Accumulated production expenditures on March 31, 1995, are $1,400,000 and on June 30, 1995, are $1,600,000. Accumulated production expenditures in excess of traced debt on March 31, 1995, are $400,000 and on June 30, 1995, are $600,000.

(ii) Under paragraph (b)(1) of this section, the amount of interest capitalized with respect to traced debt is $60,000 ($30,000 for the measurement period ending March 31, 1995, and $30,000 for the measurement period ending June 30, 1995). Under paragraph (c)(5)(ii) of this section, average excess expenditures for unit A are $250,000 ([($1,400,000 − $1,000,000) + ($1,600,000 − $1,000,000) + $0 + $0] ÷ 4). Under paragraph (c)(5)(iii)(C) of this section, average nontraced debt is $2,000,000 ([$2,000,000 + $2,000,000 + $2,000,000 + $2,000,000] ÷ 4). Under paragraph (c)(5)(iii)(B) of this section, interest incurred on nontraced debt is $200,000 ($260,000 of interest incurred on all eligible debt less $60,000 of interest incurred on traced debt). Under paragraph (c)(5)(iii)(A) of this section, the weighted average interest rate is 10 percent ($200,000 ÷ $2,000,000). Under paragraph (c)(1) of this section, Corporation X capitalizes the excess expenditure amount of $25,000 ($250,000 × 10%), because it does not exceed the total amount of interest subject to capitalization under paragraph (c)(2) of this section ($200,000). Thus, the total interest capitalized with respect to unit A during 1995 is $85,000 ($60,000 + $25,000).

(7) *Special rules where the excess expenditure amount exceeds incurred interest*—(i) *Allocation of total incurred interest to units.* For a computation period in which the sum of the excess expenditure amounts under paragraph (c)(1) of this section for all units of designated property exceeds the total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section, the amount of interest that is allocated to a unit of designated property is equal to the product of—

(A) The total amount of interest (including deferred interest) available for capitalization, as determined under paragraph (c)(2) of this section; and

(B) A fraction, the numerator of which is the average excess expenditures for the unit of designated property and the denominator of which is the sum of the average excess expenditures for all units of designated property.

(ii) *Application of related person rules to average excess expenditure.* Certain excess expenditures must be taken into account by the persons (if any) required to capitalize interest with respect to production expenditures of the taxpayer under applicable related person rules. For each computation period, the amount of average excess expenditures that must be taken into account by such persons for each unit of the taxpayer's property is computed by—

(A) Determining, for the computation period, the amount (if any) by which the excess expenditure amount for the unit exceeds the amount of interest allocated to the unit under paragraph (c)(7)(i) of this section; and

(B) Dividing the excess by the weighted average interest rate for the period.

(iii) *Special rule for corporations.* If a corporation is related to another person for the purposes of the applicable related party rules, the District Director upon examination may require that the corporation apply this paragraph (c)(7) and other provisions of the regulations by excluding deferred interest from the total interest available for capitalization.

(d) *Election not to trace debt*—(1) *General rule.* Taxpayers may elect not to trace debt. If the election is made, the average excess expenditures and weighted average interest rate under paragraph (c)(5) of this section are determined by treating all eligible debt as nontraced debt. For this purpose, debt specified in paragraph (a)(4)(ii) of this section (e.g., accounts payable) may be included in eligible debt, provided it would be treated as traced debt but for an election under this paragraph (d). The election not to trace debt is a method of accounting that applies to the determination of capitalized interest for all designated property of the taxpayer. The making or revocation of the election is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(2) *Example.* The provisions of paragraph (d)(1) of this section are illustrated by the following example.

Example. (i) Corporation X, a calendar year taxpayer, is engaged in the production of a single unit of designated property during 1995 (unit A). Corporation X adopts the taxable year as the computation period and quarterly measurement dates. At each measurement date (March 31, June 30, September 30, and December 31) Corporation X has the following outstanding indebtedness:

Noninterest-bearing accounts payable traced to unit A	$100,000
Noninterest-bearing accounts payable that are not traced to unit A	$300,000
Interest-bearing loans that are eligible debt within the meaning of paragraph (a)(4) of this section	$900,000

(ii) Corporation X elects under this paragraph (d) not to trace debt. Eligible debt at each measurement date for purposes of calculating the weighted average interest rate under paragraph (c)(5)(iii) of this section is $1,000,000 ($100,000 + $900,000).

(e) *Election to use external rate*—(1) *In general.* An eligible taxpayer may elect to use the highest applicable Federal rate (AFR) under section 1274(d) in effect during the computation period plus 3 percentage points (AFR plus 3) as a substitute for the weighted average interest rate determined under paragraph (c)(5)(iii) of this section. A taxpayer that makes this election may not trace debt. The use of the AFR plus 3 as provided under this paragraph (e)(1) constitutes a method of accounting. A taxpayer makes the election to use the AFR plus 3 method by using the AFR plus 3 as the taxpayer's weighted average interest rate, and any change to the AFR plus 3 method by a taxpayer that has never previously used the method does not require the consent of the Commissioner. Any other change to or from the use of the AFR plus 3 method under this paragraph (e)(1) (other than by reason of a taxpayer ceasing to be an eligible taxpayer) is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e). All changes to or from the AFR plus 3 method are effected on a cut-off basis.

(2) *Eligible taxpayer.* A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the average annual gross receipts of the taxpayer for the three previous taxable years do not exceed $10,000,000 (the $10,000,000 gross receipts test) and the taxpayer has met the $10,000 gross receipts for all prior taxable years beginning after December 31, 1994. For purposes of this paragraph (e)(2), the principles of section 263A(b)(2)(B) and (C) and §1.263A–3(b) apply in determining whether a taxpayer is an eligible taxpayer for a taxable year. A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the taxpayer is a small business taxpayer, as defined in §1.263A–1(j).

(f) *Selection of computation period and measurement dates and application of averaging conventions*—(1) *Computation period*—(i) *In general.* A taxpayer may (but is not required to) make the avoided cost calculation on the basis of a full taxable year. If the taxpayer uses the taxable year as the computation period, a single avoided cost calculation is made for each unit of designated property for the entire taxable year. If the taxpayer uses a computation period that is shorter than the full taxable year, an avoided cost calculation is made for each unit of designated property for each shorter computation period within the taxable year. If the taxpayer uses a shorter computation period, the computation period may not include portions of more than one taxable year and, except as provided in the case of short taxable years, each computation period within a taxable year must be the same length. In the case of a short taxable year, a taxpayer may treat a period shorter than the taxpayer's regular computation period as the first or last computation period, or as the only computation period for the year if the year is shorter than the taxpayer's regular computation period. A taxpayer must use the same computation periods for all designated property produced during a single taxable year.

(ii) *Method of accounting.* The choice of a computation period is a method of accounting. Any change in the computation period is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–1(e).

(iii) *Production period beginning or ending during the computation period.* The avoided cost method applies to the production of a unit of designated property on the basis of a full computation period, regardless of whether the production period for the unit of designated property begins or ends during the computation period.

(2) *Measurement dates*—(i) *In general.* If a taxpayer uses the taxable year as the computation period, measurement dates must occur at quarterly or more frequent regular intervals. If the taxpayer uses computation periods that are shorter than the taxable year, measurement dates must occur at least twice during each computation period and at least four times during the taxable year (or consecutive 12-month period in the case of a short taxable year). The taxpayer must use the same measurement dates for all designated property produced during a computation period. Except in the case of a computation period that differs from the taxpayer's regular computation period by reason of a short taxable year (see paragraph (f)(1)(i) of this section), measurement dates must occur at equal intervals during each computation period that falls within a single taxable year. For any computation period that differs from the taxpayer's regular computation period by reason of a short taxable year, the measurement dates used by the taxpayer during that period must be consistent with the principles and purposes of section 263A(f). A taxpayer is permitted to modify the frequency of measurement dates from year to year.

(ii) *Measurement period.* For purposes of this section, *measurement period* means the period that begins on the first day following the preceding measurement date and that ends on the measurement date.

(iii) *Measurement dates on which accumulated production expenditures must be taken into account.* The first measurement date on which accumulated production expenditures must be taken into account with respect to a unit of designated property is the first measurement date following the beginning of the production period for the unit of designated property. The final measurement date on which accumulated production expenditures with respect to a unit of designated property must be taken into account is the first measurement date following the end of the production period for the unit of designated property. Accumulated production expenditures with respect to a unit of designated property must also be taken into account on all intervening measurement dates. See §1.263A–12 to determine when the production period begins and ends.

(iv) *More frequent measurement dates.* When in the opinion of the District Director more frequent measurement dates are necessary to determine capitalized interest consistent with the principles and purposes of section 263A(f) for a particular computation period, the District Director may require the use of more frequent measurement dates. If a significant segment of the taxpayer's production activities (the first segment) requires more frequent measurement dates than another significant segment of the taxpayer's production activities, the taxpayer may request a ruling from the Internal Revenue Service permitting, for a taxable year and all subsequent taxable years, a segregation of the two segments and, notwithstanding paragraph (f)(2)(i) of this section, the use of the more frequent measurement dates for only the first segment. The request for a ruling must be made in accordance with any applicable rules relating to submissions of ruling requests. The request must be filed on or before the due date (including extensions) of the original Federal income tax return for the first taxable year to which it will apply.

(3) *Examples*. The following examples illustrate the principles of this paragraph (f):

Example 1. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts the taxable year as the computation period and quarterly measurement dates. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each quarterly measurement date (March 31, June 30, September 30, and December 31). Under paragraph (c)(5)(ii) of this section, Corporation X must calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at the end of each quarter and dividing the sum of these amounts by four. Under paragraph (c)(5)(iii) (C) of this section, Corporation X must calculate average nontraced debt by determining the amount of nontraced debt outstanding at the end of each quarter and dividing the sum of these amounts by four.

Example 2. Corporation X, a calendar year taxpayer, is engaged in the production of designated property during 1995. Corporation X adopts a 6-month computation period with two measurement dates within each computation period. Corporation X must identify traced debt, accumulated production expenditures, and nontraced debt at each measurement date (March 31 and June 30 for the first computation period and September 30 and December 31 for the second computation period). Under paragraph (c)(5)(ii) of this section, Corporation X must, for each computation period, calculate average excess expenditures for each unit of designated property by determining the amount by which accumulated production expenditures exceed traced debt for each unit at each measurement date during the period and dividing the sum of these amounts by two. Under paragraph (c)(5)(iii)(C) of this section, Corporation X must calculate average nontraced debt for each computation period by determining the amount of nontraced debt outstanding at each measurement date during the period and dividing the sum of these amounts by two.

Example 3. (i) Corporation X, a calendar year taxpayer, is engaged in the production of two units of designated property during 1995. Production of Unit A starts in 1994 and ends on June 20, 1995. Production of Unit B starts on April 15, 1995, but does not end until 1996. Corporation X adopts the taxable year as its computation period and does not elect under paragraph (d) of this section not to trace debt. Corporation X uses quarterly measurement dates and pays all interest on eligible debt in the quarter in which the interest is incurred. During 1995, Corporation X has two items of eligible debt. The debt and the manner in which it is used are as follows:

No.	Principal	Annual rate (percent)	Period outstanding	Use of proceeds
1	$1,000,000	9	1/01–9/01	Unit A.
2	2,000,000	11	6/01–12/31	Nontraced.

(ii) Based on the annual 9 percent rate of interest, Corporation X incurs $7,500 of interest during each month that Loan #1 is outstanding.

(iii) Accumulated production expenditures at the end of each quarter during 1995 are as follows:

Measurement date	Unit A	Unit B
March 31	$1,200,000	$0
June 30	1,800,000	500,000
Sept. 30	0	1,000,000
Dec. 31	0	1,600,000

(iv) Corporation X must first determine the amount of interest incurred on traced debt and capitalize the interest incurred on this debt (the traced debt amount). Loan #1 is allocated to Unit A on the March 31 and June 30 measurement dates. Accordingly, Loan #1 is treated as traced debt with respect to unit A for the measurement periods beginning January 1 and ending June 30. The interest incurred on Loan #1 during the period that Loan #1 is treated as traced debt must be capitalized with respect to Unit A. Thus, $45,000 ($7,500 per month for 6 months) is capitalized with respect to Unit A.

(v) Second, Corporation X must determine average excess expenditures for Unit A and Unit B. For Unit A, this amount is $250,000 ([$200,000 + $800,000 + $0 + $0] ÷ 4). For Unit B, this amount is $775,000 ([$0 + $500,000 + $1,000,000 + $1,600,000] ÷ 4).

(vi) Third, Corporation X must determine the weighted average interest rate and apply that rate to the average excess expenditures for Units A and B. The rate is equal to the total amount of interest incurred on nontraced debt (i.e., interest incurred on all eligible debt reduced by interest incurred on traced debt) divided by the average nontraced debt. The interest incurred on nontraced debt equals $143,333 ([$1,000,000 × 9% × 8⁄12] + [$2,000,000 × 11% × 7⁄12] − $45,000). The average nontraced debt equals $1,500,000 ([$0 + $2,000,000 + $2,000,000 + $2,000,000] ÷ 4). The weighted average interest rate of 9.56 percent ($143,333 ′ $1,500,000), is then applied to average excess expenditures for Units A and B. Accordingly, Corporation X capitalizes an additional $23,900 ($250,000 × 9.56%) with respect to Unit A and $74,090 ($775,000 × 9.56%) with respect to Unit B (the excess expenditure amounts).

(g) *Special rules*—(1) *Ordering rules*—(i) *Provisions preempted by section 263A(f).* Interest must be capitalized under section 263A(f) before the application of section 163(d) (regarding the investment interest limitation), section 163(j) (regarding the limitation on business interest expense), section 266 (regarding the election to capitalize carrying charges), section 469 (regarding the limitation on passive losses), and section 861 (regarding the allocation of interest to United States sources). Any interest that is capitalized under section 263A(f) is not taken into account as interest under those sections. However, in applying section 263A(f) with respect to the excess expenditure amount, the taxpayer must capitalize all interest that is neither investment interest under section 163(d), business interest expense under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, business interest expense, or passive interest. Any interest that is not required to be capitalized after the application of section 263A(f) is then taken into account as interest subject to sections 163(d), 163(j), 266, 469, and 861. If, after the application of section 263A(f), interest is deferred under sections 163(d), 163(j), 266, or 469, that interest is not subject to capitalization under section 263A(f) in any subsequent taxable year.

(ii) *Deferral provisions applied before this section.* Interest (including contingent interest) that is subject to a deferral provision described in this paragraph (g)(1)(ii) is subject to capitalization under section 263A(f) only in the taxable year in which it would be deducted if section 263A(f) did not apply. Deferral provisions include sections 163(e)(3), 267, 446, and 461, and all other deferral or limitation provisions that are not described in paragraph (g)(1)(i) of this section. In contrast to the provisions of paragraph (g)(1)(i) of this section, deferral provisions are applied before the application of section 263A(f).

(2) *Application of section 263A(f) to deferred interest*—(i) *In general.* This paragraph (g)(2) describes the time and manner of capitalizing and recovering the deferral amount. The deferral amount for any computation period equals the sum of—

(A) The amount of interest that is incurred on traced debt that is deferred during the computation period and is not deductible for the taxable year that includes the computation period because of a deferral provision described in paragraph (g)(1)(ii) of this section, and

(B) The shortfall amount described in paragraph (c)(4) of this section.

(ii) *Capitalization of deferral amount.* The rules described in paragraph (g)(2)(iii) of this section apply to the deferral amount unless the taxpayer elects under paragraph (g)(2)(iv) of this section to capitalize substitute costs.

(iii) *Deferred capitalization.* If the taxpayer does not elect under paragraph (g)(2)(iv) of this section to capitalize substitute costs, deferred interest to which the deferral amount is attributable (determined under any reasonable method) is capitalized in the year or years in which the deferred interest would have been deductible but for the application of section 263A(f) (the capitalization year). For this purpose, any interest that is deferred from a prior computation period is taken into account in subsequent capitalization years in the same order in which the interest was deferred. If a unit of designated property to which previously deferred interest relates is sold before the capitalization year, the deferred interest applicable to that unit of property is taken into account in the capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which previously deferred interest relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the capitalization year. See *Example 2* of paragraph (g)(2)(v) of this section.

(iv) *Substitute capitalization*—(A) *General rule*. In lieu of deferred capitalization under paragraph (g)(2)(iii) of this section, the taxpayer may elect the substitute capitalization method described in this paragraph (g)(2)(iv). Under this method, the taxpayer capitalizes for the computation period in which interest is incurred and deferred (the deferral period) costs that would be deducted but for this paragraph (g)(2)(iv) (substitute costs). The taxpayer must capitalize an amount of substitute costs equal to the deferral amount for each unit of designated property, or if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted but for this paragraph (g)(2)(iv) during the deferral period. If the entire deferral amount is capitalized pursuant to this paragraph (g)(2)(iv) in the deferral period, any interest incurred and deferred in the deferral period is neither capitalized nor deducted during the deferral period and, unless subsequently capitalized as a substitute cost under this paragraph (g)(2)(iv), is deductible in the appropriate subsequent period without regard to section 263A(f).

(B) *Capitalization of amount carried forward*. If the taxpayer has an insufficient amount of substitute costs in the deferral period, the amount by which substitute costs are insufficient with respect to each unit of designated property is a deferral amount carryforward to succeeding computation periods beginning with the next computation period. In any carryforward year, the taxpayer must capitalize an amount of substitute costs equal to the deferral amount carryforward or, if less, a prorata amount (determined in accordance with the principles of paragraph (c)(7)(i) of this section) of the total substitute costs that would be deducted during the carryforward year or years (the carryforward capitalization year) but for this paragraph (g)(2)(iv) (after applying the substitute cost method of this paragraph (g)(2)(iv) to the production of designated property in the carryforward period). If a unit of designated property to which the deferral amount carryforward relates is sold prior to the carryforward capitalization year, substitute costs applicable to that unit of property are taken into account in the carryforward capitalization year and treated as if recovered from the sale of the property. If the taxpayer continues to hold, throughout the capitalization year, a unit of depreciable property to which a deferral amount carryforward relates, the adjusted basis and applicable recovery percentages for the unit of property are redetermined for the carryforward capitalization year and subsequent years so that the increase in basis is accounted for over the remaining recovery periods beginning with the carryforward capitalization year. See *Example 2* of paragraph (g)(2)(v) of this section.

(C) *Method of accounting*. The substitute capitalization method under this paragraph (g)(2)(iv) is a method of accounting that applies to all designated property of the taxpayer. A change to or from the substitute capitalization method is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and § 1.446–1(e).

(v) *Examples*. The following examples illustrate the application of the avoided cost method when interest is subject to a deferral provision:

Example 1. (i) Corporation X is a calendar year taxpayer and uses the taxable year as it computation period. During 1995, X is engaged in the construction of a warehouse which X will use in its storage business. The warehouse is completed and placed in service in December 1995. X's average excess expenditures for 1995 equal $1,000,000. Throughout 1995, X's only outstanding debt is nontraced debt of $900,000 and $1,200,000, bearing interest at 15 percent and 9 percent, respectively, per year. Of the $243,000 interest incurred during the year ([$900,000 × 15%] + [$1,200,000

× 9%] = [$135,000 + $108,000]), $75,000 is deferred under section 267(a)(2).

(ii) X must first determine the amount of interest required to be capitalized under paragraph (c)(1) of this section for 1995 (the deferral period) without applying section 267(a)(2). The weighted average interest rate is 11.6 percent ([$135,000 + $108,000] ÷ $2,100,000), and the excess expenditure amount under paragraph (c)(1) of this section is $116,000 ($1,000,000 × 11.6%). Under paragraph (c)(4) of this section, X must then determine the amount of interest that would be capitalized by applying paragraph (c)(2) of this section without regard to the amount of deferred interest. Disregarding deferred interest, the amount of interest available for capitalization is $168,000 ([$900,000 × 15%] + [$1,200,000 × 9%] − $75,000). Thus, the full excess expenditure amount ($116,000) is capitalized from interest that is not deferred under section 267(a)(2) and there is no shortfall amount.

Example 2. (i) The facts are the same as in *Example 1,* except that $140,000 of interest is deferred under section 267 (a)(2) in 1995. The taxpayer does not elect to use the substitute capitalization method. This interest is also deferred in 1996 but would be deducted in 1997 if section 263A(f) did not apply. As in *Example 1,* the excess expenditure amount is $116,000. However, the amount of interest available for capitalization after excluding the amount of deferred interest is $103,000 ([$900,000 × 15%] + [$1,200,000 × 9%] − $140,000). Thus, only $103,000 of interest is capitalized with respect to the warehouse in 1995. Since $116,000 of interest would be capitalized if section 267(a)(2) did not apply, the deferral amount determined under paragraphs (c)(2) and (g)(2)(i) of this section is $13,000 ($116,000 − $103,000), and $13,000 of deferred interest must be capitalized in the year in which it would be deducted if section 263A(f) did not apply.

(ii) The $140,000 of interest deferred under section 267(a)(2) in 1995 would be deducted in 1997 if section 263A(f) did not apply. X is therefore required to capitalize an additional $13,000 of interest with respect to the warehouse in 1997 and must redetermine its basis and recovery percentage.

(3) *Simplified inventory method*—(i) *In general.* This paragraph (g)(3) provides a simplified method of capitalizing interest expense with respect to designated property that is inventory. Under this method, the taxpayer determines beginning and ending inventory and cost of goods sold applying all other capitalization provisions, including, for example, the simplified production method of §1.263A–2(b), but without regard to the capitalization of interest with respect to inventory. The taxpayer must establish a separate capital asset, however, in an amount equal to the aggregate interest capitalization amount (as defined in paragraph (g)(3)(iii)(C) of this section). Under the simplified inventory method, increases in the aggregate interest capitalization amount from one year to the next generally are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold.

(ii) *Segmentation of inventory*—(A) *General rule.* Under the simplified inventory method, the taxpayer first separates its total ending inventory value into segments that are equal to the total ending inventory value divided by the inverse inventory turnover rate. Each inventory segment is then assigned an age starting with one year and increasing by one year for each additional segment. The inverse inventory turnover rate is determined by finding the average of beginning and ending inventory, dividing the average by the cost of goods sold for the year, and rounding the result to the nearest whole number. Beginning and ending inventory amounts are determined using total current cost of inventory for the year (rather than carrying value). Cost of goods sold, however, may be determined using either total current cost or the taxpayer's inventory method. In addition, for purposes of this paragraph (g)(3)(ii), current costs for a year (and, if applicable, the cost of goods sold for the year under the taxpayer's inventory method) are determined without regard to the capitalization of interest with respect to inventory.

(B) *Example.* The provisions of paragraph (g)(3)(ii)(A) of this section are illustrated by the following example.

Example. X, a taxpayer using the FIFO inventory method, determines that total cost of goods sold for 1995 equals $900, and the cost of both beginning and ending inventory equals $3,000. Thus, X's inverse inventory turnover rate equals 3 (3.33 rounded to the nearest whole number). Total ending inventory of $3,000 is divided into three segments of $1,000 each. One segment is treated as 3-year-old inventory, one segment is treated as 2-year-old inventory, and one segment is treated as 1-year-old inventory.

(iii) *Aggregate interest capitalization amount*—(A) *Computation period and weighted average interest rate.* If a taxpayer elects the simplified inventory method, the taxpayer must use the taxable year as its computation period and use the weighted average interest rate determined under this paragraph (g)(3)(iii)(A) in determining the aggregate interest capitalization amount defined in paragraph (g)(3)(iii)(C) of this section and in determining the amount of interest capitalized with respect to any designated property that is not inventory. Under the simplified inventory method, the taxpayer determines the weighted average interest rate in accordance with paragraph (c)(5)(iii) of this section, treating all eligible debt (other than debt traced to noninventory property in the case of a taxpayer tracing debt) as nontraced debt (i.e., without tracing debt to inventory). A taxpayer that has elected under paragraph (e) of this section to use an external rate as a substitute for the weighted average interest rate determined under paragraph (c)(5)(iii) of this section uses the rate described in paragraph (e)(1) as the weighted average interest rate.

(B) *Computation of the tentative aggregate interest capitalization amount.* The weighted average interest rate is compounded annually by the number of years assigned to a particular inventory segment to produce an interest factor (applicable interest factor) for that segment. The amounts determined by multiplying the value of each inventory segment by its applicable interest factor are then combined to produce a tentative aggregate interest capitalization amount.

(C) *Coordination with other interest capitalization computations*—(*1*) *In general.* If the tentative aggregate interest capitalization amount for a year exceeds the aggregate interest capitalization amount (defined in paragraph (g)(3)(iii)(D) of this section) as of the close of the preceding year, then, for purposes of applying the rules of paragraph (c)(7) of this section, the excess is treated as an excess expenditure amount and the inventory to which the simplified inventory method of this paragraph (g)(3) applies is treated as a single unit of designated property. If, after these modifications, no paragraph (c)(7) interest allocation is necessary (i.e., the excess expenditure amounts for all units of designated property do not exceed the total amount of interest (including deferred interest) available for capitalization), the aggregate interest capitalization amount generally equals the tentative aggregate interest capitalization amount. If, on the other hand, a paragraph (c)(7) allocation is necessary, the tentative aggregate interest capitalization amount is generally adjusted to reflect the results of that allocation (i.e., the increase in the aggregate interest capitalization amount is limited to the amount of interest allocated to inventory, reduced, however, by any substitute costs that are capitalized with respect to inventory under applicable related party rules).

(*2*) *Deferred interest.* In determining the aggregate interest capitalization amount, the tentative aggregate interest capitalization amount is adjusted (after the application of paragraph (c)(7) of this section) as appropriate to reflect the deferred interest rules of paragraph (g)(2) of this section. The tentative aggregate interest capitalization amount would be reduced, for example, by the amount of a taxpayer's deferred interest for a taxable year unless the taxpayer has elected the substitute capitalization method under paragraph (g)(2)(iv).

(*3*) *Other coordinating provisions.* The Commissioner may prescribe, by revenue ruling or revenue procedure, additional provisions to coordinate the election and use of the simplified inventory method with other interest capitalization requirements and methods. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(D) *Treatment of increases or decreases in the aggregate interest capitalization amount.* Except as otherwise provided in this paragraph (g)(3)(iii)(D), increases in the aggregate interest capitalization amount from one year to the next are treated as reductions in interest expense, and decreases in the aggregate interest capitalization amount from one year to the next are treated as increases to cost of goods sold. To the extent a taxpayer capitalizes substitute costs under either applicable related party rules or the deferred interest rules in paragraph (g)(2) of this section, increases in the aggregate interest capitalization amount are treated as reductions in applicable substitute costs, rather than interest expense.

(E) *Example*. The provisions of this paragraph (g)(3)(iii) are illustrated by the following example.

Example. The facts are the same as in the example in paragraph (g)(3)(ii)(B) of this section, and, in addition, X determines that its weighted average interest rate for 1995 is 10 percent. Additionally, assume that X has no deferred interest in 1995 or 1996 and no deferral amount carryforward to either 1995 or 1996. (See paragraph (g)(2) of this section.) Also assume that no allocation is necessary under paragraph (c)(7) of this section in either 1995 or 1996. Under the rules of paragraph (g)(3)(ii) of this section, X divides ending inventory into segments of $1,000 each. One segment is 1-year old inventory, one segment is 2-year old inventory, and one segment is 3-year old inventory. Under paragraph (g)(3)(iii)(B) of this section, X must compute the applicable interest factor for each segment. The applicable interest factor for the 1-year old inventory is not compounded. The applicable interest factor for the 2-year old inventory is compounded for 1 year. The applicable interest factor for the 3-year old inventory is compounded for 2 years. The interest factor applied to the 1-year old inventory segment is .1. The interest factor applied to the 2-year old inventory segment is .21 [$(1.1 \times 1.1)-1$]. The interest factor applied to the 3-year old inventory is .331 [$(1.1 \times 1.1 \times 1.1)-1$]. Thus, the tentative aggregate interest capitalization amount for 1995 is $641 (1,000 × [.1 + .21 + .331]). Because X has no deferred interest in 1995, no deferral amount carryforward to 1995, and no required allocation under paragraph (c)(7) of this section in 1995, X's aggregate interest capitalization amount equals its $641 tentative aggregate interest capitalization amount. If, in 1996, X computes an aggregate interest capitalization amount of $750, the $109 increase in the amount from 1995 to 1996 would be treated as a reduction in interest expense for 1996.

(iv) *Method of accounting*. The simplified inventory method is a method of accounting that must be elected for and applied to all inventory within a single trade or business of the taxpayer (within the meaning of section 446(d) and §1.446–1(d)). This method may be elected only if the inventory in that trade or business consists only of designated property and only if the taxpayer's inverse inventory turnover rate for that trade or business (as defined in paragraph (g)(3)(ii)(A) of this section) is greater than or equal to one. A change from or to the simplified inventory method is a change in method of accounting requiring the consent of the Commissioner under section 446(e) and §1.446–(1)(e).

(4) *Financial accounting method disregarded*. The avoided cost method is applied under this section without regard to any financial or regulatory accounting principles for the capitalization of interest. For example, this section determines the amount of interest that must be capitalized without regard to Financial Accounting Standards Board (FASB) Statement Nos. 34, 71, and 90, issued by the Financial Accounting Standards Board, Norwalk, CT 06856–5116. Similarly, taxpayers are not permitted to net interest income and interest expense in determining the amount of interest that must be capitalized under this section with respect to certain restricted tax-exempt borrowings even though netting is permitted under FASB Statement No. 62.

(5) *Treatment of intercompany transactions*—(i) *General rule*. If interest capitalized under section 263A(f) by a member of a consolidated group (within the meaning of §1.1502–1(h)) with respect to a unit of designated property is attributable to a loan from another member of the group (the lending member), the intercompany transaction provisions of the consolidated return regulations do not apply to the lending member's interest income with respect to that loan, except as provided in paragraph (g)(5)(ii) of this section. For this purpose, the capitalized interest expense that is attributable to a loan from another member is determined under any method that reasonably reflects the principles of the avoided cost method, including the traced and nontraced concepts. For purposes of this paragraph (g)(5)(i) and paragraph (g)(5)(ii) of this section, in order for a method to be considered reasonable it must be consistently applied.

(ii) *Special rule for consolidated group with limited outside borrowing*. If, for any year, the aggregate amount of interest income described in paragraph (g)(5)(i) of this section for all members of the group with respect to all units of designated property exceeds the total amount of interest that is deductible for that year by all members of the group with respect to debt of a member owed to nonmembers (group deductible interest) after applying section 263A(f), the intercompany transaction provisions of the consolidated return regulations are applied to the excess, and the amount of interest income that must be taken into account by the group under paragraph (g)(5)(i) of this section is limited to the amount of the group deductible interest. The amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g)(5)(ii) is allocated among the lending members under any method that reasonably reflects each member's share of interest income described in paragraph (g)(5)(i) of this section. If a lending member has interest income that is attributable to more than one unit of designated property, the amount to which the intercompany transaction provisions of the consolidated return regulations apply by reason of this paragraph (g)(5)(ii) with respect to the member is allocated among the units in accordance with the principles of paragraph (c)(7)(i) of this section.

(iii) *Example.* The provisions of paragraph (g)(5)(ii) of this section are illustrated by the following example.

Example. (i) P and S1 are the members of a consolidated group. In 1995, S1 begins and completes the construction of a shopping center and is required to capitalize interest with respect to the construction. S1's average excess expenditures for 1995 are $5,000,000. Throughout 1995, S1's only borrowings include a $6,000,000 loan from P bearing interest at an annual rate of 10 percent ($600,000 per year). Under the avoided cost method, S1 is required to capitalize interest in the amount of $500,000 ([$600,000 ÷ $6,000,000 × 5,000,000).

(ii) P's only borrowing from unrelated lenders is a $2,000,000 loan bearing interest at an annual rate of 10 percent ($200,000 per year). Under the principles of paragraph (g)(5)(ii) of this section, because the aggregate amount of interest described in paragraph (g)(5)(i) of this section ($500,000) exceeds the aggregate amount of currently deductible interest of the group ($200,000), the intercompany transaction provisions of the consolidated return regulations apply to the excess of $300,000 and the amount of P's interest income that is subject to current inclusion by reason of paragraph (g)(5)(i) of this section is limited to $200,000.

(6) *Notional principal contracts and other derivatives.* [Reserved]

(7) *15-day repayment rule.* A taxpayer may elect to treat any eligible debt that is repaid within the 15-day period immediately preceding a quarterly measurement date as outstanding as of that measurement date for purposes of determining traced debt, average nontraced debt, and the weighted average interest rate. This election may be made or discontinued for any computation period and is not a method of accounting.

[T.D. 8584, 59 FR 67200, Dec. 29, 1994; 60 FR 16574, Mar. 31, 1995, as amended by T.D. 8584, 60 FR 47053, Sept. 11, 1995; T.D. 9129, 69 FR 29067, May 20, 2004; T.D. 9179, 70 FR 8730, Feb. 23, 2005; T.D. 9905, 85 FR 56832, Sept. 14, 2020; T.D. 9942, 86 FR 268, Jan. 5, 2021]

§ 1.263A–10 Unit of property.

(a) *In general.* The unit of property as defined in this section is used as the basis to determine accumulated production expenditures under § 1.263A–11 and the beginning and end of the production period under § 1.263A–12. Whether property is 1-year or 2-year property under § 1.263A–8(b)(1)(ii) is also determined separately with respect to each unit of property as defined in this section.

(b) *Units of real property*—(1) *In general.* A unit of real property includes any components of real property owned by the taxpayer or a related person that are functionally interdependent and an allocable share of any common feature owned by the taxpayer or a related person that is real property even though the common feature does not meet the functional interdependence test. When the production period begins with respect to any functionally interdependent component or any common feature of the unit of real property, the production period has begun for the entire unit of real property. See, however, paragraph (b)(5) of this section for rules under which the costs of a common feature or benefitted property are excluded from accumulated production expenditures for one or more measurement dates. The portion of land included in a unit of real property includes land on which real property (including a common feature) included in the unit is situated, land subject to setback restrictions with respect to such property, and any other contiguous portion of the tract of land other than land that the taxpayer holds for a purpose unrelated to the unit being produced (e.g., investment purposes, personal use purposes, or specified future development as a separate unit of real property).

(2) *Functional interdependence.* Components of real property produced by, or for, the taxpayer, for use by the taxpayer or a related person are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of property produced for sale, components of real property are functionally interdependent if they are customarily sold as a single unit. For example, the real property components of a single-family house (e.g., the land, foundation, and walls) are functionally interdependent. In contrast, components of real property that are expected to be separately placed in service or held for resale are not functionally interdependent. Thus, dwelling units within a multi-unit building that are separately placed in service or sold (within the meaning of §1.263A–12(d)(1)) are treated as functionally independent of any other units, even though the units are located in the same building.

(3) *Common features.* For purposes of this section, a common feature generally includes any real property (as defined in §1.263A–8(c)) that benefits real property produced by, or for, the taxpayer or a related person, and that is not separately held for the production of income. A common feature need not be physically contiguous to the real property that it benefits. Examples of common features include streets, sidewalks, playgrounds, clubhouses, tennis courts, sewer lines, and cables that are not held for the production of income separately from the units of real property that they benefit.

(4) *Allocation of costs to unit.* Except as provided in paragraph (b)(5) of this section, the accumulated production expenditures for a unit of real property include, in all cases, the costs that directly benefit, or are incurred by reason of the production of, the unit of real property. Accumulated production expenditures also include the adjusted basis of property used to produce the unit of real property. The accumulated costs of a common feature or land that benefits more than one unit of real property, or that benefits designated property and property other than designated property, is apportioned among the units of designated property, or among the designated property and property other than designated property, in determining accumulated production expenditures. The apportionment of the accumulated costs of the common feature (allocable share) or land (attributable land costs) generally may be made using any method that is applied on a consistent basis and that reasonably reflects the benefits provided. For example, an apportionment based on relative costs to be incurred, relative space to be occupied, or relative fair market values may be reasonable.

(5) *Treatment of costs when a common feature is included in a unit of real property*—(i) *General rule.* Except as provided in this paragraph (b)(5), the accumulated production expenditures of a unit of real property include the costs of functionally interdependent components (benefitted property) and an allocable share of the cost of common features throughout the entire production period of the unit. See §1.263A–12, relating to the production period of a unit of property.

(ii) *Production activity not undertaken on benefitted property*—(A) *Direct production activity not undertaken—(1) In general.* The costs of land attributable to a benefitted property may be treated as not included in accumulated production expenditures for a unit of real property for measurement dates prior to the first date a production activity (direct production activity), including the clearing and grading of land, has been undertaken with respect to the land attributable to the benefitted property. Thus, the costs of land attributable to a benefitted property (as opposed to land attributable to the common features) with respect to which no direct production activities have been undertaken may be treated as not included in the accumulated production expenditures of a unit of real property even though a production activity has begun on a common feature allocable to the unit.

(*2*) *Land attributable to a benefitted property.* For purposes of this paragraph (b)(5)(ii), land attributable to a benefitted property includes all land in the unit of real property that includes the benefitted property other than land for a common feature. (Thus, land attributable to a benefitted property does not include land attributable to a common feature.)

(B) *Suspension of direct production activity after clearing and grading undertaken—(1) General rule.* This paragraph (b)(5)(ii)(B) may be used to determine the accumulated production expenditures for a unit of real property, if the only production activity with respect to a benefitted property has been clearing and grading and no further direct production activity is undertaken with respect to the benefitted property for at least 120 consecutive days (i.e., direct production activity has ceased). Under this paragraph (b)(5)(ii)(B), the accumulated production expenditures attributable to a benefitted property qualifying under this paragraph (b)(5)(ii)(B) may be excluded from the accumulated production expenditures of the unit of real property even though production continues on a common feature allocable to the unit. For purposes of this paragraph (b)(5)(ii)(B), production activity is considered to occur during any time which would not qualify as a cessation of production activities under the suspension period rules of §1.263A–12(g).

(*2*) *Accumulated production expenditures.* If this paragraph (b)(5)(ii)(B) applies, accumulated production expenditures attributable to the benefitted property of the unit of real property may be treated as not included in the accumulated production expenditures for the unit starting with the first measurement period beginning after the first day of the 120 consecutive day period, but must be included in the accumulated production expenditures for the unit beginning in the measurement period in which direct production activity has resumed on the benefitted property. Accumulated production expenditures with respect to common features allocable to the unit of real property may not be excluded under this paragraph (b)(5)(ii)(B).

(iii) *Common feature placed in service before the end of production of a benefitted property.* To the extent that a common feature with respect to which all production activities to be undertaken by, or for, a taxpayer or a related person are completed is placed in service before the end of the production period of a unit that includes an allocable share of the costs of the common feature, the costs of the common feature are not treated as included in accumulated production expenditures of the unit for measurement periods beginning after the date the common feature is placed in service.

(iv) *Benefitted property sold before production completed on common feature.* If a unit of real property is sold before common features included in the unit are completed, the production period of the unit ends on the date of sale. Thus, common feature costs actually incurred and properly allocable to the unit as of the date of sale are excluded from accumulated production expenditures for measurement periods beginning after the date of sale. Common feature costs properly allocable to the unit and actually incurred after the sale are not taken into account in determining accumulated production expenditures.

(v) *Benefitted property placed in service before production completed on common feature.* Where production activities remain to be undertaken on a common feature allocable to a unit of real property that includes benefitted property, the costs of the benefitted property are not treated as included in the accumulated production expenditures for the unit for measurement periods beginning after the date the benefitted property is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person with respect to the benefitted property are completed.

(6) *Examples*. The principles of paragraph (b) of this section are illustrated by the following examples:

Example 1. B, an individual, is in the trade or business of constructing custom-built houses for sale. B owns a 10-acre tract upon which B intends to build four houses on 2-acre lots. In addition, on the remaining 2 acres B plans to construct a perimeter road that benefits the four houses and is not held for the production of income separately from the sale of the houses. In 1995, B begins constructing the perimeter road and clears the land for one house. Under the principles of paragraph (b)(1) of this section, each planned house (including attributable land) is part of a separate unit of real property (house unit). Under the principles of paragraph (b)(3) of this section, the perimeter road (including attributable land) constitutes a common feature with respect to each planned house (i.e., benefitted property). In accordance with paragraph (b)(1), the production period for all four house units begins when production commences on the perimeter road in 1995. In addition, under the principles of paragraph (b)(4) of this section, the accumulated production expenditures for the four house units include the allocable costs of the road. In addition, for the house with respect to which B has cleared the land, the accumulated production expenditures for the house unit include the land costs attributable to the house. See paragraph (b)(5)(i) of this section. However, the accumulated production expenditures for each of the three house units that include a house for which B has not yet undertaken a direct production activity do not include the land costs attributable to the house. See paragraph (b)(5)(ii) of this section.

Example 2. Assume the same facts as *Example 1*, except that B undertakes no further direct production activity with respect to the house for which the land was cleared for a period of at least 120 days but continues constructing the perimeter road during this period. In accordance with paragraph (b)(5)(ii)(B) of this section, B may exclude the accumulated production expenditures attributable to the benefitted property from the accumulated production expenditures of the house unit starting with the first measurement period that begins after the first day of the 120 consecutive day period. B must include the accumulated production expenditures attributable to the benefitted property in the accumulated production expenditures for the house unit beginning with the measurement period in which direct production resumes on the benefitted property. The house unit will continue to include the accumulated production expenditures attributable to the perimeter road during the period in which direct production activity was suspended on the benefitted property.

Example 3. (i) D, a corporation, is in the trade or business of developing commercial real property. D owns a 20-acre tract upon which D intends to build a shopping center with 150 stores. D intends to lease the stores. D will also provide on the 20 acres a 1500-car parking lot, which is not held by D for the production of income separately from the stores in the shopping center. Additionally, D will not produce any other common features as part of the project. D intends to complete the shopping center in phases and expects that each store will be placed in service independently of any other store.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each store (including attributable land) is part of a separate unit of real property (store unit). The 1500-car parking lot is a common feature benefitting each store, and D must include an allocable share of the parking lots in each store unit. See paragraphs (b)(1) and (b)(3). In accordance with paragraph (b)(5)(i), D includes in the accumulated production expenditures for each store unit during each store unit's production period: the costs capitalized with respect to the store (including attributable land costs in accordance with paragraph (b)(5) of this section) and an allocable share of the parking lot costs (including attributable land costs in accordance with paragraph (b)(5) of this section). Under paragraph (b)(4), the portion of the parking lot costs that is included in the accumulated production expenditures of a store unit is determined using a reasonable method of allocation.

Example 4. X, a real estate developer, begins a project to construct a condominium building and a convenience store for the benefit of the condominium. X intends to separately lease the convenience store. Because the convenience store is held for the production of income separately from the condominium units that it benefits, the convenience store is not a common feature with respect to the condominium building. Instead, the convenience store is a separate unit of property with a separate production period and for which a separate determination of accumulated production expenditures must be made.

Example 5. (i) In 1995, X, a real estate developer, begins a project consisting of a condominium building and a common swimming pool that is not held for the production of income separately from the condominium sales. The condominium building consists of 10 stories, and each story is occupied by a single condominium. Production of the swimming pool begins in January. No direct production activity is undertaken on any condominium until September, when direct production activity commences on each condominium. On December 31, 1995, 1 condominium that was completed in December has been sold, 3 condominiums that were completed in December have not been sold, and 6 condominiums are only partially complete; additionally, the swimming pool is completed. X is a calendar year taxpayer that uses a full taxable year as the computation period, and quarterly measurement dates.

(ii) Under paragraphs (b)(1) and (b)(2) of this section, each condominium (including attributable land) is part of a separate unit of real property. Under the principles of paragraph (b)(3) of this section, the swimming pool is a common feature with respect to each condominium and under paragraph (b)(4) of this section the cost of the swimming pool is allocated equally among the condominiums.

(iii) Under paragraph (b)(1) of this section, the production period of each of the 10 condominium units begins in January when production of the swimming pool begins. On X's March 31, 1995, and June 30, 1995, measurement dates, the accumulated production expenditures for each condominium unit include the allocable costs of the swimming pool, but not the land costs attributable to the condominium because no direct production activity has been undertaken on the condominium. See paragraph (b)(5)(ii)(A) of this section. On X's September 30, 1995, and December 31, 1995, measurement dates, the accumulated production expenditures for each unit include the allocable costs of the swimming pool, and the costs of the condominium (including attributable land costs) because a direct production activity has commenced on the condominium. See paragraph (b)(5)(i) of this section.

(iv) The production period for the condominium unit that includes the condominium that is sold as of the end of 1995 ends on the date the condominium is sold. See paragraph (b)(5)(iv) of this section. The production period of each unit that is ready to be held for sale ends when all production activities have been completed on the unit, in this case on December 31, 1995, the date that the swimming pool included in the unit is completed. See §1.263A–12(d). Accordingly, interest capitalization ceases for each such unit that is sold or ready to be held for sale as of the end of 1995 (including each unit's allocable share of the completed swimming pool).

(v) The production periods for the condominium units that include the condominiums that are only partially complete at the end of 1995 continue after 1995. The accumulated production expenditures for each partially completed condominium unit continue to include the costs of the condominium (including attributable land costs) in addition to the costs of an allocable share of the completed swimming pool (including attributable land costs).

Example 6. Assume the same facts as in *Example 5*, except that the swimming pool is only partially complete as of the end of 1995. Under these facts, X capitalizes no interest during 1996 for the 1 unit that includes the condominium sold during 1995 (including the costs of the allocable share of the swimming pool). See paragraph (b)(5)(iv) of this section. However, with respect to the 6 condominiums that are partially complete and the 3 condominiums that are completed but unsold, interest capitalization continues after the end of 1995. The accumulated production expenditures for each of these 9 units include the costs of an allocable share of the swimming pool. See paragraph (b)(5)(i) of this section. In determining the costs of an allocable share of the swimming pool included in the accumulated production expenditures for each of the 9 units, X includes all costs of the swimming pool properly allocable to each unit, including those cost incurred as of the date of the sale of unit 1 that may have been used under applicable administrative procedures (e.g., Rev. Proc. 92–29, 1992–1 C.B. 748) in determining the basis of unit 1 solely for purposes of computing gain or loss on the sale of unit 1. See §601.601(d)(2)(ii)(*b*) of this chapter.

Example 7. (i) Assume the same facts as in *Example 5*, except that X intends to lease rather than sell the condominiums and the completed swimming pool is placed in service for depreciation purposes on December 31, 1995. Additionally, assume that all 10 condominiums are partially completed at the end of 1995.

(ii) Under these facts, because the swimming pool is a common feature that is placed in service separately from the condominiums that it benefits, under paragraph (b)(5)(iii) of this section, the accumulated production expenditures of each of the condominium units do not include the costs of the allocable share of the swimming pool after 1995.

(c) *Units of tangible personal property.* Components of tangible personal property are a single unit of property if the components are functionally interdependent. Components of tangible personal property that are produced by, or for, the taxpayer, for use by the taxpayer or a related person, are functionally interdependent if the placing in service of one component is dependent on the placing in service of the other component by the taxpayer or a related person. In the case of tangible personal property produced for sale, components of tangible personal property are functionally interdependent if they are customarily sold as a single unit. For example, if an aircraft manufacturer customarily sells completely assembled aircraft, the unit of property includes all components of a completely assembled aircraft. If the manufacturer also customarily sells aircraft engines separately, any engines that are reasonably expected to be sold separately are treated as single units of property.

(d) *Treatment of installations.* If the taxpayer produces or is treated as producing any property that is installed on or in other property, the production activity and installation activity relating to each unit of property generally are not aggregated for purposes of this section. However, if the taxpayer is treated as producing and installing any property for use by the taxpayer or a related person or if the taxpayer enters into a contract requiring the taxpayer to install property for use by a customer, the production activity and installation activity are aggregated for purposes of this section.

[T.D. 8584, 59 FR 67207, Dec. 29, 1994; 60 FR 16574, 16575, Mar. 31, 1995]

§ 1.263A–11 Accumulated production expenditures.

(a) *General rule. Accumulated production expenditures* generally means the cumulative amount of direct and indirect costs described in section 263A(a) that are required to be capitalized with respect to the unit of property (as defined in § 1.263A–10), including interest capitalized in prior computation periods, plus the adjusted bases of any assets described in paragraph (d) of this section that are used to produce the unit of property during the period of their use. Accumulated production expenditures may also include the basis of any property received by the taxpayer in a nontaxable transaction.

(b) *When costs are first taken into account*—(1) *In general.* Except as provided in paragraph (c)(1) of this section, costs are taken into account in the computation of accumulated production expenditures at the time and to the extent they would otherwise be taken into account under the taxpayer's method of accounting (e.g., after applying the requirements of section 461, including the economic performance requirement of section 461(h)). Costs that have been incurred and capitalized with respect to a unit of property prior to the beginning of the production period are taken into account as accumulated production expenditures beginning on the date on which the production period of the property begins (as defined in § 1.263A–12(c)). Thus, for example, the cost of raw land acquired for development, the cost of a leasehold in mineral properties acquired for development, and the capitalized cost of planning and design activities are taken into account as accumulated production expenditures beginning on the first day of the production period. For purposes of determining accumulated production expenditures on any measurement date during a computation period, the interest required to be capitalized for the computation period is deemed to be capitalized on the day immediately following the end of the computation period. For any subsequent measurement dates and computation periods, that interest is included in accumulated production expenditures. If the cost of land or common features is allocated among planned units of property that are completed in phases, any portion of the cost properly allocated to completed units is not reallocated to any incomplete units of property.

(2) *Dedication rule for materials and supplies.* The costs of raw materials, supplies, or similar items are taken into account as accumulated production expenditures when they are incurred and dedicated to production of a unit of property. *Dedicated* means the first date on which the raw materials, supplies, or similar items are specifically associated with the production of any unit of property, including by record, assignment to the specific job site, or physical incorporation. In contrast, in the case of a component or subassembly that is reasonably expected to be become a part of (e.g., be incorporated into) any unit of property, costs incurred (including dedicated raw materials) for the component or subassembly are taken into account as accumulated production expenditures during the production of any portion of the component or subassembly and prior to its connection with (e.g., incorporation into) any specific unit of property. For purposes of the preceding

sentence, components and subassemblies must be aggregated at each measurement date in a reasonable manner that is consistent with the purposes of section 263A(f).

(c) *Property produced under a contract*—(1) *Customer.* If a unit of property produced under a contract is designated property under §1.263A–8(d)(2)(i) with respect to the customer, the customer's accumulated production expenditures include any payments under the contract that represent part of the purchase price of the unit of designated property or, to the extent costs are incurred earlier than payments are made (determined on a cumulative basis for each unit of designated property), any part of such price for which the requirements of section 461 have been satisfied. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting. The customer's accumulated production expenditures also include any other costs incurred by the customer, such as interest, or any other direct or indirect costs that are required to be capitalized under section 263A(a) and the regulations thereunder with respect to the production of the unit of designated property.

(2) *Contractor.* If a unit of property produced under a contract is designated property under §1.263A–8(d)(2)(ii) with respect to the contractor, the contractor must treat the cumulative amount of payments made by the customer under the contract attributable to the unit of property as a reduction in the contractor's accumulated production expenditures. The customer has made a payment under this section if the transaction would be considered a payment by a taxpayer using the cash receipts and disbursements method of accounting.

(d) *Property used to produce designated property*—(1) *In general.* Accumulated production expenditures include the adjusted bases (or portion thereof) of any equipment, facilities, or other similar assets, used in a reasonably proximate manner for the production of a unit of designated property during any measurement period in which the asset is so used. Examples of assets used in a reasonably proximate manner include machinery and equipment used directly or indirectly in the production process, such as assembly-line structures, cranes, bulldozers, and buildings. A taxpayer apportions the adjusted basis of an asset used in the production of more than one unit of designated property in a measurement period among such units of designated property using reasonable criteria corresponding to the use of the asset, such as machine hours, mileage, or units of production. If an asset used in a reasonably proximate manner for the production of a unit of designated property is temporarily idle (within the meaning of §1.263A–1(e)(3)(iii)(E)) for an entire measurement period, the adjusted basis of the asset is excluded from the accumulated production expenditures for the unit during that measurement period. Notwithstanding this paragraph (d)(1), the portion of the depreciation allowance for equipment, facilities, or any other asset that is capitalized with respect to a unit of designated property in accordance with §1.263A–1(e)(3)(ii)(I) is included in accumulated production expenditures without regard to the extent of use under this paragraph (d)(1) (i.e., without regard to whether the asset is used in a reasonably proximate manner for the production of the unit of designated property).

(2) *Example.* The following example illustrates how the basis of an asset is allocated on the basis of time:

Example. In 1995, X uses a bulldozer exclusively to clear the land on several adjacent real estate development projects, A, B, and C. A, B, and C are treated as separate units of property under the principles of §1.263A–10. X decides to allocate the basis of the bulldozer among the three projects on the basis of time. At the end of the first quarter of 1995, the production period has commenced for all three projects. The bulldozer was operated for 30 hours on project A, 80 hours on project B, and 10 hours on project C, for a total of 120 hours for the entire period. For purposes of determining accumulated production expenditures as of the end of the first quarter, ¼ of the adjusted basis of the bulldozer is allocated to project A, ⅔ to project B, and $1/12$ to project C. Nonworking hours, regularly scheduled nonworking days, or other periods in which the bulldozer is temporarily idle (within the meaning of

§ 1.263A–1(e)(3)(iii)(E)) during the measurement period are not taken into account in allocating the basis of the bulldozer.

(3) *Excluded equipment and facilities.* The adjusted bases of equipment, facilities, or other assets that are not used in a reasonably proximate manner to produce a unit of property are not included in the computation of accumulated production expenditures. For example, the adjusted bases of equipment and facilities, including buildings and other structures, used in service departments performing administrative, purchasing, personnel, legal, accounting, or similar functions, are excluded from the computation of accumulated production expenditures under this paragraph (d)(3).

(e) *Improvements*—(1) *General rule.* If an improvement constitutes the production of designated property under $1.263A–8(d)(3), accumulated production expenditures with respect to the improvement consist of—

(i) All direct and indirect costs required to be capitalized with respect to the improvement,

(ii) In the case of an improvement to a unit of real property—

(A) An allocable portion of the cost of land, and

(B) For any measurement period, the adjusted basis of any existing structure, common feature, or other property that is not placed in service or must be temporarily withdrawn from service to complete the improvement (associated property) during any part of the measurement period if the associated property directly benefits the property being improved, the associated property directly benefits from the improvement, or the improvement was incurred by reason of the associated property. See, however, the de minimis rule under paragraph (e)(2) of this section that applies in the case of associated property.

(iii) In the case of an improvement to a unit of tangible personal property, the adjusted basis of the asset being improved if that asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

(2) *De minimis rule.* For purposes of paragraph (e)(1)(ii) of this section, the total costs of all associated property for an improvement unit (associated property costs) are excluded from the accumulated production expenditures for the improvement unit during its production period if, on the date the production period of the unit begins, the taxpayer reasonably expects that at no time during the production period of the unit will the accumulated production expenditures for the unit, determined without regard to the associated property costs, exceed 5 percent of the associated property costs.

(f) *Mid-production purchases.* If a taxpayer purchases a unit of property for further production, the taxpayer's accumulated production expenditures include the full purchase price of the property plus, in accordance with the principles of paragraph (e) of this section, additional direct and indirect costs incurred by the taxpayer.

(g) *Related person costs.* The activities of a related person are taken into account in applying the classification thresholds under § 1.263A–8(b)(1)(ii)(B) and (C), and in determining the production period of a unit of designated property under § 1.263A–12. However, only those costs incurred by the taxpayer are taken into account in the taxpayer's accumulated production expenditures under this section because the related person includes its own capitalized costs in the related person's accumulated production expenditures with respect to any unit of designated property upon which the parties engage in mutual production activities. For purposes of the preceding sentence, the accumulated production expenditures of any property transferred to a taxpayer in a nontaxable transaction are treated as accumulated production expenditures incurred by the taxpayer.

(h) *Installation.* If the taxpayer installs property that is purchased by the taxpayer, accumulated production expenditures include the cost of the property that is installed in addition to the direct and indirect costs of installation.

[T.D. 8584, 59 FR 67210, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 1.263A–12 Production period.

(a) *In general.* Capitalization of interest is required under § 1.263A–9 for computation periods (within the meaning of § 1.263A–9(f)(1)) that include the production period of a unit of designated property. In contrast, section 263A(a) requires the capitalization of all other direct or indirect costs, such as insurance, taxes, and storage, that directly benefit or are incurred by reason of the production of property without regard to whether they are incurred during a period in which production activity occurs.

(b) *Related person activities.* Activities performed and costs incurred by a person related to the taxpayer that directly benefit or are incurred by reason of the taxpayer's production of designated property are taken into account in determining the taxpayer's production period (regardless of whether the related person is performing only a service or is producing a subassembly or component that the related person is required to treat as an item of designated property). These activities and the related person's costs are also taken into account in determining whether tangible personal property produced by the taxpayer is 1-year or 2-year property under § 1.263A–8(b)(1)(ii) (B) and (C).

(c) *Beginning of production period*—(1) *In general.* A separate production period is determined for each unit of property defined in § 1.263A–10. The production period begins on the date that production of the unit of property begins.

(2) *Real property.* The production period of a unit of real property begins on the first date that any physical production activity (as defined in paragraph (e) of this section) is performed with respect to a unit of real property. See § 1.263A–10(b)(1). The production period of a unit of real property produced under a contract begins for the contractor on the date the contractor begins physical production activity on the property. The production period of a unit of real property produced under a contract begins for the customer on the date either the customer or the contractor begins physical production activity on the property.

(3) *Tangible personal property.* The production period of a unit of tangible personal property begins on the first date by which the taxpayer's accumulated production expenditures, including planning and design expenditures, are at least 5 percent of the taxpayer's total estimated accumulated production expenditures for the property unit. Thus, the beginning of the production period is determined without regard to whether physical production activity has commenced. The production period of a unit of tangible personal property produced under a contract begins for the contractor when the contractor's accumulated production expenditures, without any reduction for payments from the customer, are at least 5 percent of the contractor's total estimated accumulated production expenditures. The production period for a unit of tangible personal property produced under a contract begins for the customer when the customer's accumulated production expenditures are at least 5 percent of the customer's total estimated accumulated production expenditures.

(d) *End of production period*—(1) *In general.* The production period for a unit of property produced for self use ends on the date that the unit is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. The production period for a unit of property produced for sale ends on the date that the unit is ready to be held for sale and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See, however, § 1.263A–10(b)(5)(iv) providing an exception for common features in the case of a benefitted property that is sold. In the case of a unit of property produced under a contract, the production period for the customer ends when the property is placed in service by the customer and all production activities reasonably expected to be undertaken are complete (i.e., generally, no earlier than when the customer takes delivery). In the case of property that is customarily aged (such as tobacco, wine, or whiskey) before it is sold, the production period includes the aging period.

(2) *Special rules.* The production period does not end for a unit of property prior to the completion of physical production activities by the taxpayer even though the property is held for sale or

lease, since all production activities reasonably expected to be undertaken by the taxpayer with respect to such property have not in fact been completed. See, however, §1.263A–10(b)(5) regarding separation of certain common features.

(3) *Sequential production or delivery.* The production period ends with respect to each unit of property (as defined in §1.263A–10) and its associated accumulated production expenditures as the unit of property is completed within the meaning of paragraph (d)(1) of this section, without regard to the production activities or costs of any other units of property. Thus, for example, in the case of separate apartments in a multi-unit building, each of which is a separate unit of property within the meaning of §1.263A–10, the production period ends for each separate apartment when it is ready to be held for sale or placed in service within the meaning of paragraph (d)(1) of this section. In the case of a single unit of property that merely undergoes separate and distinct stages of production, the production period ends at the same time (i.e., when all separate stages of production are completed with respect to the entire amount of accumulated production expenditures for the property).

(4) *Examples.* The provisions of paragraph (d) of this section are illustrated by the following examples:

Example 1. E is engaged in the original construction of a high-rise office building with two wings. At the end of 1995, Wing #1, but not Wing #2, is placed in service. Moreover, at the end of 1995, all production activities reasonably expected to be undertaken on Wing #1 are completed. In accordance with §1.263A–10(b)(1), Wing #1 and Wing #2 are separate units of designated property. E may stop capitalizing interest on Wing #1 but not on Wing #2.

Example 2. F is in the business of constructing finished houses. F generally paints and finishes the interior of the house, although this does not occur until a potential buyer is located. Because F reasonably expects to undertake production activity (painting and finishing), the production period of each house does not end until these activities are completed.

(e) *Physical production activities*—(1) *In general.* The term *physical production activities* includes any physical activity that constitutes production within the meaning of §1.263A–8(d)(1). The production period begins and interest must be capitalized with respect to real property if any physical production activities are undertaken, whether alone or in preparation for the construction of buildings or other structures, or with respect to the improvement of existing structures. For example, the clearing of raw land constitutes the production of designated property, even if only cleared prior to resale.

(2) *Illustrations.* The following is a partial list of activities any one of which constitutes a physical production activity with respect to the production of real property:

(i) Clearing, grading, or excavating of raw land;

(ii) Demolishing a building or gutting a standing building;

(iii) Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables, and wiring;

(iv) Undertaking structural, mechanical, or electrical activities with respect to a building or other structure; or

(v) Engaging in landscaping activities.

(f) *Activities not considered physical production.* The activities described in paragraphs (f)(1) and (f)(2) of this section are not considered physical production activities:

(1) *Planning and design.* Soil testing, preparing architectural blueprints or models, or obtaining building permits.

(2) *Incidental repairs.* Physical activities of an incidental nature that may be treated as repairs under §1.162–4.

(g) *Suspension of production period*—(1) *In general.* If production activities related to the production of a unit of designated property cease for at least 120 consecutive days (cessation period), a taxpayer may suspend the capitalization of interest with respect to the unit of designated property starting with the first measurement period that begins after the first day in which production ceases. The taxpayer must resume the capitalization of interest with respect to a unit beginning with the measurement period during which production activities resume. In addition, production activities are not considered to have ceased if they cease because of circumstances inherent in the production process, such as normal adverse weather conditions, scheduled plant shutdowns, or delays due to design or construction flaws, the obtaining of a permit or license, or the settlement of groundfill to construct property. Interest incurred on debt that is traced debt with respect to a unit of designated property during the suspension period is subject to capitalization with respect to the production of other units of designated property as interest on nontraced debt. See § 1.263A–9(c)(5)(i) of this section. For applications of the avoided cost method after the end of the suspension period, the accumulated production expenditures for the unit include the balance of accumulated production expenditures as of the beginning of the suspension period, plus any additional capitalized costs incurred during the suspension period. No further suspension of interest capitalization may occur unless the requirements for a new suspension period are satisfied.

(2) *Special rule.* If a cessation period spans more than one taxable year, the taxpayer may suspend the capitalization of interest with respect to a unit beginning with the first measurement period of the taxable year in which the 120-day period is satisfied.

(3) *Method of accounting.* An election to suspend interest capitalization under paragraph (g)(1) of this section is a method of accounting that must be consistently applied to all units that satisfy the requirements of paragraph (g)(1) of this section. However, the special rule in paragraph (g)(2) of this section is applied on an annual basis to all units of an electing taxpayer that satisfy the requirements of paragraph (g)(2) of this section.

(4) *Example.* The provisions of paragraph (g)(1) of this section are illustrated by the following example.

Example. (i) D, a calendar-year taxpayer, began production of a residential housing development on January 1, 1995. D, in applying the avoided cost method, chose a taxable year computation period and quarterly measurement dates. On April 10, 1995, all production activities ceased with respect to the units in the development until December 1, 1996. The cessation, which occurred for a period of at least 120 consecutive days, was not attributable to circumstances inherent in the production process. With respect to the units in the development, D incurred production expenditures of $2,000,000 from January 1, 1995 through April 10, 1995. D incurred interest of $100,000 on traced debt with respect to the units for the period beginning January 1, 1995, and ending June 30, 1995. D did not incur any production expenditures for the more than 20-month cessation beginning April 10, 1995, and ending December 1, 1996, but incurred $200,000 of production expenditures from December 1, 1996, through December 31, 1996.

(ii) D is required to capitalize the $100,000 interest on traced debt incurred during the two measurement periods beginning January 1, 1995, and ending June 30, 1995. Because D satisfied the 120-day rule under this paragraph (g), D is not required to capitalize interest with respect to the accumulated production expenditures for the units for the measurement period beginning July 1, 1995, and ending September 30, 1995, which is the first measurement period that begins after the date production activities cease. D is rquired to resume interest capitalization with respect to the $2,300,000 (2,000,000 + 100,000 + 200,000) of accumulated production expenditures for the units for the measurement period beginning October 1, 1996, and ending December 31, 1996 (the measurement period during which production activities resume). Accordingly, D may suspend the capitalization of interest with respect to the units from July 1, 1995, through September 30, 1996.

[T.D. 8584, 59 FR 67212, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 1.263A–13 Oil and gas activities.

(a) *In general.* This section provides rules that are to be applied in tandem with §§ 1.263A–8 through 1.263A–12, 1.263A–14, and 1.263A–15 in capitalizing interest with respect to the development (within the meaning of section 263A(g)) of oil or gas property. For this purpose, oil or gas property consists of each separate operating mineral interest in oil or gas as defined in section 614(a), or, if a taxpayer makes an election under section 614(b), the aggregate of two or more separate operating mineral interests in oil or gas as described in section 614(b) (section 614 property). Thus, an oil or gas property is designated property unless the de minimis rule applies. A taxpayer must apply the rules in paragraph (c) of this section if the taxpayer cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of other wells planned with respect to the property. If a taxpayer can establish such a plan at the beginning of the production period of the first well drilled on the property, the taxpayer may either apply the rules of paragraph (c) of this section or treat each of the planned wells as a separate unit and partition the leasehold acquisition costs and costs of common features based on the number of planned well units.

(b) *Generally applicable rules*—(1) *Beginning of production period*—(i) *Onshore activities.* In the case of onshore oil or gas development activities, the production period for a unit begins on the first date physical site preparation activities (such as building an access road, leveling a site for a drilling rig, or excavating a mud pit) are undertaken with respect to the unit.

(ii) *Offshore activities.* In the case of offshore development activities, the production period for a unit begins on the first date physical site preparation activities, other than activities undertaken with respect to expendable wells, are undertaken with respect to the unit. For purposes of the preceding sentence, the first physical site preparation activity undertaken with respect to a section 614 property is generally the first activity undertaken with respect to the anchoring of a platform (e.g., drilling to drive the piles). For purposes of this section, an expendable well is a well drilled solely to determine the location and delineation of offshore hydrocarbon deposits.

(2) *End of production period.* The production period ends for a productive well unit on the date the well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. See § 1.263A–12(d).

(3) *Accumulated production expenditures*—(i) *Costs included.* Accumulated production expenditures for a well unit include the following costs (to the extent they are not intangible drilling and development costs allowable as a deduction under section 263(c), 263(i), or 291(b)(2)): the costs of acquiring the section 614 leasehold and the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 leasehold; the cost of real property associated with developing the section 614 property (e.g., casing); the basis of real property that constitutes a common feature within the meaning of § 1.263A–10(b)(3); and the adjusted basis of property used to produce property (such as a mobile rig, drilling ship, or an offshore drilling platform).

(ii) *Improvement unit.* To the extent section 614 costs are allocated to a well unit, the undepleted portion of those section 614 costs must also be included in the accumulated production expenditures for any improvement unit (within the meaning of § 1.263A–8(d)(3)) with respect to that well unit.

(c) *Special rules when definite plan not established*—(1) *In general.* The special rules of this paragraph (c) must be applied by a taxpayer that cannot establish, at the beginning of the production period of the first well drilled on the property, a definite plan that identifies the number and location of the wells planned with respect to the property. A taxpayer than can establish such a plan is permitted, but not required, to apply the rules of this paragraph (c), provided the rules of this paragraph (c) are consistently applied for all the taxpayer's oil or gas properties for which a definite plan can be established.

(2) *Oil and gas units*—(i) *First productive well unit.* Until the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, a first productive well unit includes the section 614 property and all real property associated with the development of the section 614 property. Thus, for example, a first productive well unit includes the section 614 property and real property associated with any nonproductive well drilled on the section 614 property on or before the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed. For purposes of this section, a productive well is a well that produces in commercial quantities. See

paragraph (c)(5) of this section, which provides a special rule whereby the costs of a section 614 property and common feature costs for a section 614 property generally are included only in the accumulated production expenditures for the first productive well unit.

(ii) *Subsequent units.* Generally, real property associated with each productive or nonproductive well with respect to which production activities begin after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, constitutes a unit of real property. Additionally, a productive or nonproductive well that is included in a first productive well unit and for which development continues after the date the first productive well is placed in service and all production activities reasonably expected to be undertaken by, or for, the taxpayer or a related person are completed, generally is treated as a separate unit of property after that date. See, however, paragraph (c)(5) of this section, which provides rules for the treatment of costs included in the accumulated production expenditures of a first productive well unit.

(3) *Beginning of production period*—(i) *First productive well unit.* The beginning of the production period of the first productive well unit is determined as provided in paragraph (b) of this section.

(ii) *Subsequent wells.* In applying paragraph (b) of this section to subsequent well units (as described in paragraph (c)(2)(ii) of this section), any activities occurring prior to the date the production period ends for the first productive well unit are not taken into account in determining the beginning of the production period for the subsequent well units.

(4) *End of production period.* The end of the production period for both the first productive well unit and subsequent productive well units is determined as provided in paragraph (b)(2) of this section. See §1.263A–12(d). Nonproductive wells included in the first productive well unit need not be plugged and abandoned for the production period to end for a first productive well unit.

(5) *Accumulated production expenditures*—(i) *First productive well unit.* The accumulated production expenditures for a first productive well unit include all costs incurred with respect to the section 614 property and associated real property at any time through the end of the production period for the first productive well unit. Thus, the costs of acquiring the section 614 property, the costs of taxes and similar items that are required to be capitalized under section 263A(a) with respect to the section 614 property, and the costs of common features, that are incurred at any time through the end of the production period of the first productive well unit (section 614 costs) are included in the accumulated production expenditures for the first productive well unit.

(ii) *Subsequent well unit.* The accumulated production expenditures for a subsequent well do not include any costs included in the accumulated production expenditures for a first productive well unit. In the event that section 614 costs or common feature costs with respect to a section 614 property are incurred subsequent to the end of the production period of the first productive well unit, those common feature costs and undepleted section 614 costs are allocated among the accumulated production expenditures of wells being drilled as of the date such costs are incurred.

(6) *Allocation of interest capitalized with respect to first productive well unit.* Interest attributable to any productive or nonproductive well included in the first productive well unit (within the meaning of paragraph (c)(2)(ii) of this section) is allocated among and capitalized to the basis of the property associated with the first productive well unit. See §1.263A–8(a)(2).

(7) *Example.* The provisions of this paragraph (c) are illustrated by the following example.

Example. (i) Corporation Z, an oil company, acquired a section 614 property in an onshore tract, Tract B, for development. In 1995, Corporation Z began site preparation activities on Tract B and also commenced drilling Well 1 on Tract B. Corporation Z was unable to establish, as provided in paragraph (a) of this section, a definite plan identifying the number and location of other wells planned on Tract B. In 1996, Corporation Z began drilling Well 2. On May 1, 1997, Well 2, a productive well, was placed in service and all production activities reasonably expected to be undertaken with respect to Well 2 were completed. By that date, also, Well 1 was abandoned.

(ii) Well 2 is a first productive well (within the meaning of paragraph (c)(2)(i) of this section). Well 1 is a nonproductive well drilled prior to a first productive well. Under paragraph (c) of this section, Corporation Z must treat both Well 1 and Well 2 as part of the first productive well unit on the section 614 property. In accordance with paragraphs (c)(3) and (c)(4) of this section, the production period of the first productive well unit begins on the date physical site preparation activities are undertaken with respect to Well 1 in 1995 and ends on May 1, 1997, the date that Well 2 is placed in service and all production activities reasonably expected to be undertaken are completed. In accordance with paragraph (c)(5) of this section, the accumulated production expenditures for the first productive well unit include, among other capitalized costs, the entire section 614 property costs capitalized with respect to Tract B and all common feature costs incurred with respect to the section 614 property through May 1, 1997.

(iii) Any well that Corporation Z begins after May 1, 1997, is a separate unit of property. See paragraph (c)(2)(ii) of this section. Under paragraph (c)(3)(ii) of this section, the production period for any such well unit begins on the first day after May 1, 1997, on which Corporation Z undertakes physical site preparation activities with respect to the well unit. Moreover, Corporation Z does not include any of the section 614 property costs in the accumulated production expenditures for any well unit begun after May 1, 1997.

[T.D. 8584, 59 FR 67213, Dec. 29, 1994; 60 FR 16575, Mar. 31, 1995]

§ 1.263A–14 Rules for related persons.

Taxpayers must account for average excess expenditures allocated to related persons under applicable administrative pronouncements interpreting section 263A(f). See § 601.601(d)(2)(ii)(*b*) of this chapter.

[T.D. 8584, 59 FR 67215, Dec. 29, 1994]

§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

(a) *Effective dates*—(1) Sections 1.263A–8 through 1.263A–15 generally apply to interest incurred in taxable years beginning on or after January 1, 1995. In the case of property that is inventory in the hands of the taxpayer, however, these sections are effective for taxable years beginning on or after January 1, 1995. Changes in methods of accounting necessary as a result of the rules in §§ 1.263A–8 through 1.263A–15 must be made under the terms and conditions prescribed by the Commissioner. Under these terms and conditions, the principles of § 1.263A–7 must be applied in revaluing inventory property.

(2) For taxable years beginning before January 1, 1995, taxpayers must take reasonable positions on their federal income tax returns when applying section 263A(f). For purposes of this paragraph (a)(2), a reasonable position is a position consistent with the temporary regulations, revenue rulings, revenue procedures, notices, and announcements concerning section 263A applicable in taxable years beginning before January 1, 1995. See § 601.601(d)(2)(ii)(*b*) of this chapter. For this purpose, Notice 88–99, 1988–2 C.B. 422, applies to taxable years beginning after August 17, 1988, in the case of inventory, and to interest incurred in taxable years beginning after August 17, 1988, in all other cases. Finally, under administrative procedures issued by the Commissioner, taxpayers may elect early application of §§ 1.263A–8 through 1.263A–15 to taxable years beginning on or after January 1, 1994, in the case of inventory property, and to interest incurred in taxable years beginning on or after January 1, 1994, in the case of property that is not inventory in the hands of the taxpayer.

(3) Section 1.263A–9(a)(4)(ix) generally applies to interest incurred in taxable years beginning on or after May 20, 2004. In the case of property that is inventory in the hands of the taxpayer, § 1.263A–9(a)(4)(ix) applies to taxable years beginning on or after May 20, 2004. Taxpayers may elect to apply § 1.263A–9(a)(4)(ix) to interest incurred in taxable years beginning on or after January 1, 1995, or, in the case of property that is inventory in the hands of the taxpayer, to taxable years beginning on or after January 1, 1995. A change in a taxpayer's treatment of interest to a method consistent with § 1.263A–9(a)(4)(ix) is a change in method of accounting to which sections 446 and 481 apply.

(4) Section 1.263A–9(g)(1)(i) applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of that section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations (as defined in §1.163(j)–1(b)(37)), and, if applicable, §§1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

(5) The last sentence of each of §1.263A–8(a)(1) and §1.263A–9(e)(2) apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the last sentence of each of §1.263A–8(a)(1) and §1.263A–9(e)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

(b) *Transitional rule for accumulated production expenditures*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, costs incurred before the effective date of section 263A are included in accumulated production expenditures (within the meaning of §1.263A–11) with respect to noninventory property only to the extent those costs were required to be capitalized under section 263 when incurred and would have been taken into account in determining the amount of interest required to be capitalized under former section 189 (relating to the capitalization of real property interest and taxes) or pursuant to an election that was in effect under section 266 (relating to the election to capitalize certain carrying charges).

(2) *Property used to produce designated property.* The basis of property acquired prior to 1987 and used to produce designated noninventory property after December 31, 1986, is included in accumulated production expenditures in accordance with §1.263A–11(d) without regard to whether the basis would have been taken into account under former section 189 or section 266.

(c) *Anti-abuse rule.* The interest capitalization rules contained in §§1.263A–8 through 1.263A–15 must be applied by the taxpayer in a manner that is consistent with and reasonably carries out the purposes of section 263A(f). For example, in applying §1.263A–10, regarding the definition of a unit of property, taxpayers may not divide a single unit of property to avoid property classifying the property as designated property. Similarly, taxpayers may not use loans in lieu of advance payments, tax-exempt parties, loan restructurings at measurement dates, or obligations bearing an unreasonably low rate of interest (even if such rate equals or exceeds the applicable Federal rate under section 1274(d)) to avoid the purposes of section 263A(f). For purposes of this paragraph (c), the presence of back-to-back loans with different rates of interest, and other uses of related parties to facilitate an avoidance of interest capitalization, evidences abuse. In such cases, the District Director may, based upon all the facts and circumstances, determine the amount of interest that must be capitalized in a manner that is consistent with and reasonably carries out the purposes of section 263A(f).

[T.D. 8584, 59 FR 67215, Dec. 29, 1994, as amended by T.D. 8728, 62 FR 42062, Aug. 5, 1997; T.D. 9179, 70 FR 8730, Feb. 23, 2005; T.D. 9905, 85 FR 56832, Sept. 14, 2020; 86 FR 32186, June 17, 2021]

§ 1.264–1 Premiums on life insurance taken out in a trade or business.

(a) *When premiums are not deductible.* Premiums paid by a taxpayer on a life insurance policy are not deductible from the taxpayer's gross income, even though they would otherwise be deductible as trade or business expenses, if they are paid on a life insurance policy covering the life of any officer or employee of the taxpayer, or any person (including the taxpayer) who is financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary of the policy. For additional provisions relating to the nondeductibility of premiums paid on life insurance policies (whether under section 162 or any other section of the Code), see section 262, relating to personal, living, and family expenses, and section 265, relating to expenses allocable to tax-exempt income.

(b) *When taxpayer is a beneficiary.* If a taxpayer takes out a policy for the purpose of protecting himself from loss in the event of the death of the insured, the taxpayer is considered a beneficiary directly or indirectly under the policy. However, if the taxpayer is not a beneficiary under the policy, the premiums so paid will not be disallowed as deductions merely because the taxpayer may derive a benefit from the increased efficiency of the officer or employee insured. See section 162 and the regulations thereunder. A taxpayer is considered a beneficiary under a policy where, for example, he, as a principal member of a partnership, takes out an insurance policy on his own life irrevocably designating his partner as the sole beneficiary in order to induce his partner to retain his investment in the partnership. Whether or not the taxpayer is a beneficiary under a policy, the proceeds of the policy paid by reason of the death of the insured may be excluded from gross income whether the beneficiary is an individual or a corporation, except in the case of (1) certain transferees, as provided in section 101(a)(2); (2) portions of amounts of life insurance proceeds received at a date later than death under the provisions of section 101(d); and (3) life insurance policy proceeds which are includible in the gross income of a husband or wife under section 71 (relating to alimony) or section 682 (relating to income of an estate or trust in case of divorce, etc.). (See section 101(e).) For further reference, see, generally, section 101 and the regulations thereunder.

§ 1.264–2 Single premium life insurance, endowment, or annuity contracts.

Amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium life insurance or endowment contract, or to purchase or to continue in effect a single premium annuity contract purchased (whether from the insurer, annuitant, or any other person) after March 1, 1954, are not deductible under section 163 or any other provision of chapter 1 of the Code. This prohibition applies even though the insurance is not on the life of the taxpayer and regardless of whether or not the taxpayer is the annuitant or payee of such annuity contract. A contract is considered a single premium life insurance, endowment, or annuity contract, for the purposes of this section, if substantially all the premiums on the contract are paid within four years from the date on which the contract was purchased, or if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

§ 1.264–3 Effective date; taxable years ending after March 1, 1954, subject to the Internal Revenue Code of 1939.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.264–2, to the extent that they relate to amounts paid or accrued on indebtedness incurred or continued to purchase or carry a single premium annuity contract purchased after March 1, 1954, and to the extent they consider a contract a single premium life insurance, endowment, or annuity contract if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract, shall also apply to taxable years beginning before January 1, 1954, and ending after March 1, 1954, and to taxable years beginning after December 31, 1953, and ending after March 1, 1954, but before August 17, 1954, although such years are subject to the Internal Revenue Code of 1939.

§ 1.264–4 Other life insurance, endowment, or annuity contracts.

(a) *General rule.* Except as otherwise provided in paragraphs (d) and (e) of this section, no deduction shall be allowed under section 163 or any other provision of chapter 1 of the Code for any amount (determined under paragraph (b) of this section) paid or accrued during the taxable year on indebtedness incurred or continued to purchase or continue in effect a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) if such indebtedness is incurred pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise). For the purposes of the preceding sentence, the term *of purchase* includes the payment of part or all of the premiums on a contract, and not merely payment of the premium due upon inital issuance of the contract. The rule of this paragraph applies whether or not the taxpayer is the insured, payee, or annuitant under the contract. the rule of this paragraph does not apply to contracts purchased by the taxpayer on or before August 6, 1963, even though there is a substantial increase in premiums after such date. The rule of this paragraph does not apply to any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (including a contract treated as a single premium contract); the treatment of such amounts is governed by §1.264–2.

(b) *Determination of amount not allowed.* The amount not allowed as a deduction under paragraph (a) of this section is determined with reference to the entire amount of borrowing to purchase or carry the contract, and is not limited with reference to the amount of borrowing of increases in the cash value. The rule of this paragraph may be illustrated by the following example:

Example. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first policy year, A pays the annual premium by means other than by borrowing. For the second, third, fourth, and fifth policy years, A continues the policy in effect by incurring indebtedness pursuant to a plan referred to in paragraph (a) of this section. The years and amounts applicable to the policy are as follows:

Years	Cumulative cash value of contract	Total loan outstanding	Interest paid at 4.8 percent
1964	$370	0	0
1965	2,175	$2,200	$105.60
1966	4,000	4,400	211.20
1967	5,865	6,600	316.80
1968	7,745	8,800	422.40

On these facts (assuming that none of the exceptions contained in paragraph (d) of this section are applicable), no deduction is allowed for the interest paid during the year 1968. Moreover, the interest deduction will be disallowed for the taxable years 1965 through 1967 if such taxable years are not closed by reason of the statute of limitations or other rule of law.

(c) *Special rules.* For purposes of this section:

(1) *Determination of existence of a plan which contemplates systematic borrowing*—(i) *In general.* The determination of whether indebtedness is incurred or continued pursuant to a plan referred to in paragraph (a) of this section shall be made on the basis of all the facts and circumstances in each case. Unless the taxpayer shows otherwise, in the case of borrowing in connection with premiums for more than three years, the existence of a plan referred to in paragraph (a) of this section will be presumed. The mere fact that a taxpayer does not borrow to pay a premium in a particular year does not in and of itself preclude the existence of a plan referred to in paragraph (a) of this section. A plan referred to in paragraph (a) of this section need not exist at the time the contract is entered into, but may come into existence at any time during the 7-year period following the taxpayer's purchase of the contract or following a substantial increase (referred to in paragraph (d)(1) of this section) in premiums on the contract.

(ii) *Premium attributable to more than one year.* For purposes of subdivision (i) of this subparagraph, if the stated annual premiums due on a contract vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year. The preceding sentence shall not apply where the borrowing is in connection with a substantially increased premium within the meaning of paragraph (d)(1) of this section.

(2) *Direct or indirect.* A plan referred to in paragraph (a) of this section may contemplate direct or indirect borrowing of increases in cash value of the contract directly or indirectly to pay premiums and many contemplate borrowing either from an insurance carrier, from a bank, or from any other person. Thus, for example, if a taxpayer borrows $100,000 from a bank and uses the funds to purchase securities, later borrows $100,000 from a second bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan referred to in paragraph (a) of this section to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable). Moreover, a plan referred to in paragraph (a) of this section need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.

(d) *Exceptions.* No deduction shall be denied under paragraph (a) of this section with respect to any amount paid or accrued during a taxable year on indebtedness incurred or continued as part of a plan referred to in paragraph (a) of this section if any of the following exceptions apply.

(1) *The 7-year exception*—(i) *In general.* No part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. For purposes of this exception, in the event of a substantial increase in any annual premium on a contract, a new 7-year period begins on the date such increased premium is paid. If premiums on a contract are payable other than on an annual basis (for example, monthly), the annual premium is the aggregate of premiums due for the year. See paragraph (c)(1)(ii) of this section for cases where one premium on a contract paid by means of indebtedness may be considered as more than one annual premium.

(ii) *Application of borrowings.* For purposes of subdivision (i) of this subparagraph, if during a 7-year period referred to in such subdivision the taxpayer, directly or indirectly, borrows with respect to more than one annual premium on a contract, such borrowing shall be considered first attributable to the premium for the current policy year (within the meaning of subdivision (iii) of this subparagraph) and then attributable to premiums for prior policy years beginning with the most recent prior policy year (but not including any prior policy year to the extent that such taxpayer has indebtedness outstanding with respect to the premium for such prior policy year). If such borrowing exceeds the premiums paid for the current policy year and for prior policy years and the taxpayer has, with respect to the current policy year, deposited premiums in advance of the due date of such premiums, such excess borrowing shall be considered indebtedness incurred to carry the contract which is attributable to the premiums deposited for succeeding policy years beginning with the premium for the next succeeding policy year. The preceding sentence shall not apply to a single premium contract referred to in §1.264–2.

(iii) *Current policy year.* For purposes of subdivision (ii) of this subparagraph, the term *current policy year* refers to the policy year which begins with or within the taxable year of the taxpayer.

(iv) *Illustrations.* The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in the amount of $100,000 with an annual gross premium of $2,200. For the first four policy years, A initially pays the annual premium by means other than borrowing. On January 1, 1968, pursuant to a plan referred to in paragraph (a) of this section, A borrows $10,000 with respect to the policy. Such borrowing is considered first attributable to paying the premium for the year 1968 and then attributable to paying the premiums for the years 1967, 1966, 1965, and 1964 (in part). No deduction is allowed for the interest paid by A on the $10,000 indebtedness during the year 1968.

Example 2. The facts are the same as in *Example 1,* except that on January 1, 1964, A pays the first annual premium and deposits an amount equal to the second and third annual premiums, all such amounts initially being paid or deposited by means other than borrowing. On January 1, 1965, A deposits an amount equal to the fourth, fifth, and sixth annual premiums, and borrows $4,400 pursuant to a plan referred to in paragraph (a) of this section. Such borrowing is considered attributable to the premiums paid for the policy years 1965 and 1964. On January 1, 1966, A deposits an amount equal to the seventh, eighth, and ninth annual premiums, and borrows $6,600 pursuant to such plan. Such borrowing is considered attributable to the premium paid for the policy year 1966 and deposited for the policy years 1967 and 1968. No deduction is allowed for interest paid by A on the $11,000 indebtedness during 1966. Moreover, the interest deduction will be disallowed for the taxable year 1965. However, if this contract is treated as a single premium contract under §1.264–2 (by reason of deposit with the insurer of an amount for payment of a substantial number of future premiums), the deduction for interest on indebtedness incurred or continued to purchase or carry the contract would be denied without reference to this section.

(2) *The $100 exception.* The total amount paid or accrued during the taxable year by the taxpayer who has entered one or more plans referred to in paragraph (a) of this section for which (without regard to this subparagraph) no deduction would be allowable under paragraph (a) of this section does not exceed $100. Where the amount so paid or accrued during the taxable year exceeds $100, the entire amount shall be subject to the general rule of paragraph (a) of this section.

(3) *The unforeseen events exception.* The amount is paid or accrued by the taxpayer on indebtedness incurred because of an unforeseen substantial loss of such taxpayer's income or an unforeseen substantial increase in such taxpayer's financial obligations. A loss of income or increase in financial obligations is not unforeseen, within the meaning of this subparagraph, if at the time of the purchase of the contract such event was or could have been foreseen. College education expenses are foreseeable; however, if college expenses substantially increase, then to the extent that such increases are unforeseen, this exception will apply. This exception applies only if the plan referred to in paragraph (a) of this section arises because of the unforeseen event. Thus, for example, if a taxpayer or his family incur substantial unexpected medical expenses or the taxpayer is laid off from his job, and for that reason systematically borrows against the cash value of a previously purchased contract, the deduction for the interest paid on the loan will not be denied, whether or not the loan is used to pay a premium on the contract.

(4) *The trade or business exception.* The indebtedness is incurred by the taxpayer in connection with his trade or business. To be within this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance. Thus, if a taxpayer pledges a life insurance, endowment, or annuity contract as part of the collateral for a loan to finance the expansion of inventory or capital improvements for his business, no part of the deduction for interest on such loan will be denied under paragraph (a) of this section. Borrowing by a business taxpayer to finance business life insurance such as under so-called keyman, split dollar, or stock retirement plans is not considered to be incurred in connection with the taxpayer's trade or business within the meaning of this subparagraph. The determination of whether the indebtedness is incurred in connection with the taxpayer's trade or business, within the meaning of this exception, rather than to finance cash value life insurance shall be made on the basis of all the facts and circumstances. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation M each year borrows substantial sums to carry on its business. Corporation M agrees to provide a retirement plan for its employees and purchases level premium life insurance to fund its obligation under the plan. The mere fact that M Corporation purchases a cash value life insurance policy will not cause its deduction for interest paid on its normal indebtedness to be denied even though the policy is later used as part of the collateral for its normal indebtedness.

Example 2. Corporation R has $200,000 of bonds outstanding and purchases cash value life insurance policies on several of its key employees. Such purchase by R Corporation will not, of itself, cause its deduction for interest on its bonded indebtedness to be denied. If, however, the premiums on the life insurance policies are $10,000 each year, the cash value increases by $8,000 each year, and R Corporation increases its indebtedness by $10,000 each year, its deduction for interest on such indebtedness will not be allowed under the rule of paragraph (a) of this section. On the other hand, the absence of such a directly parallel increase will not of itself establish that the deduction for interest is allowable.

(e) *Applicability of section.* The rules of this section apply with respect to taxable years beginning after December 31, 1963, but only with respect to contracts purchased after August 6, 1963. With respect to contracts entered into on or before August 6, 1963, but purchased or acquired whether from the insurer, insured, or any other person (other than by gift, bequest, or inheritance, or in a transaction to which section 381(a) of the Code applies) after such date, the rules of this section apply after such purchase or acquisition.

[T.D. 6773, 29 FR 15751, Nov. 24, 1964]

§ 1.265–1 Expenses relating to tax-exempt income.

(a) *Nondeductibility of expenses allocable to exempt income.* (1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

(2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt interest income.

(b) *Exempt income and nonexempt income.* (1) As used in this section, the term *class of exempt income* means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by Subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is:

(i) Wholly excluded from gross income under any provision of Subtitle A, or

(ii) Wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law.

(2) As used in this section the term *nonexempt income* means any income which is required to be included in gross income.

(c) *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) *Statement of classes of exempt income; records.* (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way attributable to a class of exempt income.

(2) The taxpayer shall keep such records as will enable him to make the allocations required by this section. See section 6001 and the regulations thereunder.

§ 1.265–2 Interest relating to tax exempt income.

(a) *In general.* No amount shall be allowed as a deduction for interest on any indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from tax under subtitle A of the Code, such as municipal bonds, Panama Canal loan 3-percent bonds, or obligations of the United States, the interest on which is wholly exempt from tax under Subtitle A, and which were issued after September 24, 1917, and not originally subscribed for by the taxpayer. Interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry (1) obligations of the United States issued after September 24, 1917, the interest on which is not wholly exempt from the taxes imposed under Subtitle A of the Code, or (2) obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, is deductible. For rules as to the inclusion in gross income of interest on certain governmental obligations, see section 103 and the regulations thereunder.

(b) *Special rule for certain financial institutions.* (1) No deduction shall be disallowed, for taxable years ending after February 26, 1964, under section 265(2) for interest paid or accrued by a financial institution which is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and which is subject to the banking laws of the State in which it is incorporated, on face-amount certificates (as defined in section 2(a)(15) of the Investment Company Act of 1940) issued by such institution and on amounts received for the purchase of such certificates to be issued by the institution, if the average amount of obligations, the interest on which is wholly exempt from the taxes imposed by Subtitle A of the Code, held by such institution during the taxable year, does not exceed 15 percent of the average amount of the total assets of such institution during such year. See subparagraph (3) of this paragraph for treatment of interest paid or accrued on face-amount certificates where the figure is in excess of 15 percent. Interest expense other than that paid or accrued on face-amount certificates or on amounts received for the purchase of such certificates does not come within the rules of this paragraph.

(2) This subparagraph is prescribed under the authority granted the Secretary or his delegate under section 265(2) to prescribe regulations governing the determination of the average amount of tax-exempt obligations and of the total assets held during an institution's taxable year. The average amount of tax-exempt obligations held during an institution's taxable year shall be the average of the amounts of tax-exempt obligations held at the end of each month ending within such taxable year. The average amount of total assets for a taxable year shall be the average of the total assets determined at the beginning and end of the institution's taxable year. If the Commissioner, however, determines that any such amount is not fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be, held by such institution during such taxable year, then the Commissioner shall determine the amount which is fairly representative of the average amount of tax-exempt obligations or total assets, as the case may be. The percentage which the average amount of tax-exempt obligations is of the average amount of total assets is determined by dividing the average amount of tax-exempt obligations by the average amount of total assets, and multiplying by 100. The amount of tax-exempt obligations means that portion of the total assets of the institution which consists of obligations the interest on which is wholly exempt from tax under Subtitle A of the Code, and valued at their adjusted basis, appropriately adjusted for amortization of premium or discount. Total assets means the sum of the money, plus the aggregate of the adjusted basis of the property other than money held by the taxpayer in good faith for the purpose of the business. Such adjusted basis for any asset is its adjusted basis for determining gain upon sale or exchange for Federal income tax purposes.

(3) If the percentage computation required by subparagraph (2) of this paragraph results in a figure in excess of 15 percent for the taxable year, there is interest that does not come within the special rule for certain financial institutions contained in section 265(2). The amount of such interest is obtained by multiplying the total interest paid or accrued for the taxable year on face-amount certificates and on amounts received for the purchase of such certificates by the percentage figure equal to the excess of the percentage figure computed under subparagraph (2) of this paragraph over 15 percent. See paragraph (a) for the disallowance of interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from tax under Subtitle A of the Code.

(4) Every financial institution claiming the benefits of the special rule for certain financial institutions contained in section 265(2) shall file with its return for the taxable year:

(i) A statement showing that it is a face-amount certificate company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1 and following) and that it is subject to the banking laws of the State in which it is incorporated.

(ii) A detailed schedule showing the computation of the average amount of tax-exempt obligations, the average amount of total assets of such institutions, and the total amount of interest paid or accrued on face-amount certificates and on amounts received for the purchase of such certificates for the taxable year.

[T.D. 6927, 32 FR 13221, Sept. 19, 1967]

§ 1.265–3 Nondeductibility of interest relating to exempt-interest dividends.

(a) *In general.* No deduction is allowed to a shareholder of a regulated investment company for interest on indebtedness that relates to exempt-interest dividends distributed by the company to the shareholder during the shareholder's taxable year.

(b) *Interest relating to exempt-interest dividends.* (1) All or a portion of the interest on an indebtedness relates to exempt-interest dividends if the indebtedness is either incurred or continued to purchase or carry shares of stock of a regulated investment company that distributes exempt-interest dividends (as defined in section 852(b)(5) of the Code) to the holder of the shares during the shareholder's taxable year.

(2) To determine the amount of interest that relates to the exempt-interest dividends the total amount of interest paid or accrued on the indebtedness is multiplied by a fraction. The numerator of the fraction is the amount of exempt-interest dividends received by the shareholder. The denominator of the fraction is the sum of the exempt-interest dividends and taxable dividends received by the shareholder (excluding capital gain dividends received by the shareholder and capital gains required to be included in the shareholder's computation of long-term capital gains under section 852(b)(3)(D)).

[T.D. 7601, 44 FR 16013, Mar. 16, 1979]

§ 1.266–1 Taxes and carrying charges chargeable to capital account and treated as capital items.

(a)(1) *In general.* In accordance with section 266, items enumerated in paragraph (b)(1) of this section may be capitalized at the election of the taxpayer. Thus, taxes and carrying charges with respect to property of the type described in this section are chargeable to capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of Subtitle A of the Code. No deduction is allowable for any items so treated.

(2) See §§ 1.263A–8 through 1.263A–15 for rules regarding the requirement to capitalize interest, that apply prior to the application of this section. After applying §§ 1.263A–8 through 1.263A–15, a taxpayer may elect to capitalize interest under section 266 with respect to designated property within the meaning of § 1.263A–8(b), provided a computation under any provision of the Internal Revenue Code is not thereby materially distorted, including computations relating to the source of deductions.

(b) *Taxes and carrying charges.* (1) The taxpayer may elect, as provided in paragraph (c) of this section, to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of Subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1). The items thus chargeable to capital account are:

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive:

(*a*) Interest on a loan (but not theoretical interest of a taxpayer using his own funds),

(*b*) Taxes of the owner of such real property measured by compensation paid to his employees,

(*c*) Taxes of such owner imposed on the purchase of materials, or on the storage, use, or other consumption of materials, and

(*d*) Other necessary expenditures,

paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed. The development or construction work with respect to which such items are incurred may relate to unimproved and unproductive real estate whether the construction work will make the property productive of income subject to tax (as in the case of a factory) or not (as in the case of a personal residence), or may relate to property already improved or productive (as in the case of a plant addition or improvement, such as the construction of another floor on a factory or the installation of insulation therein).

(iii) In the case of personal property:

(*a*) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(*b*) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(*c*) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property,

paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

(iv) Any other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account.

(2) The sole effect of section 266 is to permit the items enumerated in subparagraph (1) of this paragraph to be chargeable to capital account notwithstanding that such items are otherwise expressly deductible under the provisions of Subtitle A of the Code. An item not otherwise deductible may not be capitalized under section 266.

(3) In the absence of a provision in this section for treating a given item as a capital item, this section has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of this section, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

(c) *Election to charge taxes and carrying charges to capital account.* (1) If for any taxable year there are two or more items of the type described in paragraph (b)(1) of this section, which relate to the same project to which the election is applicable, the taxpayer may elect to capitalize any one or more of such items even though he does not elect to capitalize the remaining items or to capitalize items of the same type relating to other projects. However, if expenditures for several items of the same type are incurred with respect to a single project, the election to capitalize must, if exercised, be exercised as to all items of that type. For purposes of this section, a *project* means, in the case of items described in paragraph (b)(1)(ii) of this section, a particular development of, or construction of an improvement to, real property, and in the case of items described in paragraph (b)(1)(iii) of this section, the transportation and installation of machinery or other fixed assets.

(2)(i) An election with respect to an item described in paragraph (b)(1)(i) of this section is effective only for the year for which it is made.

(ii) An election with respect to an item described in:

(*a*) Paragraph (b)(1)(ii) of this section is effective until the development or construction work described in that subdivision has been completed;

(*b*) Paragraph (b)(1)(iii) of this section is effective until the later of either the date of installation of the property described in that subdivision, or the date when such property is first put into use by the taxpayer;

(*c*) Paragraph (b)(1)(iv) of this section is effective as determined by the Commissioner.

Thus, an item chargeable to capital account under this section must continue to be capitalized for the entire period described in this subdivision applicable to such election although such period may consist of more than one taxable year.

(3) If the taxpayer elects to capitalize an item or items under this section, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with respect to the same project or to different projects) which the taxpayer elects to treat as chargeable to capital account. Elections filed for taxable years beginning before January 1, 1954, and for taxable years ending before August 17, 1954, under section 24(a)(7) of the Internal Revenue Code of 1939, and the regulations thereunder, shall have the same effect as if they were filed under this section. See section 7807(b)(2).

(d) The following examples are illustrative of the application of the provisions of this section:

Example 1. In 1956 and 1957 A pays annual taxes and interest on a mortgage on a piece of real property. During 1956, the property is vacant and unproductive, but throughout 1957 A operates the property as a parking lot. A may capitalize the taxes and mortgage interest paid in 1956, but not the taxes and mortgage interest paid in 1957.

Example 2. In February 1957, B began the erection of an office building for himself. B in 1957, in connection with the erection of the building, paid $6,000 social security taxes, which in his 1957 return he elected to capitalize. B must continue to capitalize the social security taxes paid in connection with the erection of the building until its completion.

Example 3. Assume the same facts as in *Example 2* except that in November 1957, B also begins to build a hotel. In 1957 B pays $3,000 social security taxes in connection with the erection of the hotel. B's election to capitalize the social security taxes paid in erecting the office building started in February 1957 does not bind him to capitalize the social security taxes paid in erecting the hotel; he may deduct the $3,000 social security taxes paid in erecting the hotel.

Example 4. In 1957, M Corporation began the erection of a building for itself, which will take three years to complete. M Corporation in 1957 paid $4,000 social security taxes and $8,000 interest on a building loan in connection with this building. M Corporation may elect to capitalize the social security taxes although it deducts the interest charges.

Example 5. C purchases machinery in 1957 for use in his factory. He pays social security taxes on the labor for transportation and installation of the machinery, as well as interest on a loan to obtain funds to pay for the machinery and for transportation and installation costs. C may capitalize either the social security taxes or the interest, or both, up to the date of installation or until the machinery is first put into use by him, whichever date is later.

(e) *Allocation.* If any tax or carrying charge with respect to property is in part a type of item described in paragraph (b) of this section and in part a type of item or items with respect to which no election to treat as a capital item is given, a reasonable proportion of such tax or carrying charge, determined in the light of all the facts and circumstances in each case, shall be allocated to each item. The rule of this paragraph may be illustrated by the following example:

Example. N Corporation, the owner of a factory in New York on which a new addition is under construction, in 1957 pays its general manager, B, a salary of $10,000 and also pays a New York State unemployment insurance tax of $81 on B's salary. B spends nine-tenths of his time in the general business of the firm and the remaining one-tenth in supervising the construction work. N Corporation treats as expenses $9,000 of B's salary, and charges the remaining $1,000 to capital account. N Corporation may elect to capitalize $8.10 of the $81 New York State unemployment insurance tax paid in 1957 since such tax is deductible under section 164.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 8584, 59 FR 67215, Dec. 29, 1994]

§ 1.267A–1 Disallowance of certain interest and royalty deductions.

(a) *Scope.* This section and §§ 1.267A–2 through 1.267A–5 provide rules regarding when a deduction for any interest or royalty paid or accrued is disallowed under section 267A. Section 1.267A–2 describes hybrid and branch arrangements. Section 1.267A–3 provides rules for determining income inclusions and provides that certain amounts are not amounts for which a deduction is disallowed. Section 1.267A–4 provides an imported mismatch rule. Section 1.267A–5 sets forth definitions and special rules that apply for purposes of section 267A. Section 1.267A–6 illustrates the application of section 267A through examples. Section 1.267A–7 provides applicability dates.

(b) *Disallowance of deduction.* This paragraph (b) sets forth the exclusive circumstances in which a deduction is disallowed under section 267A. Except as provided in paragraph (c) of this section, a specified party's deduction for any interest or royalty paid or accrued (the amount paid or accrued with respect to the specified party, a *specified payment*) is disallowed under section 267A to the extent that the specified payment is described in this paragraph (b). *See also* § 1.267A–5(b)(5) (treating structured payments as interest paid or accrued for purposes of section 267A and the regulations in this part under section 267A). A specified payment is described in this paragraph (b) to the extent that it is—

(1) A disqualified hybrid amount, as described in § 1.267A–2 (hybrid and branch arrangements);

(2) A disqualified imported mismatch amount, as described in § 1.267A–4 (payments offset by a hybrid deduction); or

(3) A specified payment for which the requirements of the anti-avoidance rule of § 1.267A–5(b)(6) are satisfied.

(c) *De minimis exception.* Paragraph (b) of this section does not apply to a specified party for a taxable year in which the sum of the specified party's specified payments that but for this paragraph (c) would be described in paragraph (b) of this section is less than $50,000. For purposes of this paragraph (c), specified parties that are related (within the meaning of § 1.267A–5(a)(14)) are treated as a single specified party.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020]

§ 1.267A–2 Hybrid and branch arrangements.

(a) *Payments pursuant to hybrid transactions*—(1) *In general.* If a specified payment is made pursuant to a hybrid transaction, then, subject to § 1.267A–3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that—

(i) A specified recipient of the payment does not include the payment in income, as determined under § 1.267A–3(a) (to such extent, a *no-inclusion*); and

(ii) The specified recipient's no-inclusion is a result of the payment being made pursuant to the hybrid transaction. For purposes of this paragraph (a)(1)(ii), the specified recipient's no-inclusion is a result of the specified payment being made pursuant to the hybrid transaction to the extent that the no-inclusion would not occur were the specified recipient's tax law to treat the payment as interest or a royalty, as applicable. See § 1.267A–6(c)(1) and (2) for examples illustrating the application of paragraph (a) of this section.

(2) *Definition of hybrid transaction*—(i) *In general.* The term *hybrid transaction* means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes but are not so treated for purposes of the tax law of a specified recipient of the payment. Examples of a hybrid transaction include an instrument a payment with respect to which is treated as interest for U.S. tax purposes but, for purposes of a specified recipient's tax law, is treated as a distribution with respect to equity or a recovery of principal with respect to indebtedness.

(ii) *Special rules*—(A) *Long-term deferral.* A specified payment is deemed to be made pursuant to a hybrid transaction if the taxable year in which a specified recipient of the payment takes the payment into account in income under its tax law (or, based on all the facts and circumstances, is reasonably expected to take the payment into account in income under its tax law) ends more than 36 months after the end of the taxable year in which the specified party would be allowed a deduction for the payment under U.S. tax law. In addition, if the tax law of a specified recipient of the specified payment does not impose an income tax, then such tax law does not cause the payment to be deemed to be made pursuant to a hybrid transaction under this paragraph (a)(2)(ii)(A). See §1.267A–6(c)(8) for an example illustrating the application of this paragraph (a)(2)(ii)(A) in the context of the imported mismatch rule.

(B) *Royalties treated as payments in exchange for property under foreign law.* In the case of a specified payment that is a royalty for U.S. tax purposes and for purposes of the tax law of a specified recipient of the payment is consideration received in exchange for property, the tax law of the specified recipient is not treated as causing the payment to be made pursuant to a hybrid transaction.

(C) *Coordination with disregarded payment rule.* A specified payment is not considered made pursuant to a hybrid transaction if the payment is a disregarded payment, as described in paragraph (b)(2) of this section.

(3) *Payments pursuant to securities lending transactions, sale-repurchase transactions, or similar transactions.* This paragraph (a)(3) applies if a specified payment is made pursuant to a repo transaction and is not regarded under a foreign tax law, but another amount connected to the payment (the *connected amount*) is regarded under such foreign tax law. For purposes of this paragraph (a)(3), a *repo transaction* means a transaction one or more payments with respect to which are treated as interest (as defined in §1.267A–5(a)(12)) or a structured payment (as defined in §1.267A–5(b)(5)(ii)) for U.S. tax purposes and that is a securities lending transaction or sale-repurchase transaction (including as described in §1.861–2(a)(7)), or other similar transaction or series of related transactions in which legal title to property is transferred and the property (or similar property, such as securities of the same class and issue) is reacquired or expected to be reacquired. For example, this paragraph (a)(3) applies if a specified payment arising from characterizing a repo transaction of stock in accordance with its substance (that is, characterizing the specified payment as interest) is not regarded as such under a foreign tax law but an amount consistent with the form of the transaction (such as a dividend) is regarded under such foreign tax law. When this paragraph (a)(3) applies, the determination of the identity of a specified recipient of the specified payment under the foreign tax law is made with respect to the connected amount. In addition, if the specified recipient includes the connected amount in income (as determined under §1.267A–3(a), by treating the connected amount as the specified payment), then the amount of the specified recipient's no-inclusion with respect to the specified payment is correspondingly reduced. Further, the principles of this paragraph (a)(3) apply to cases similar to repo transactions in which a foreign tax law does not characterize the transaction in accordance with its substance. See §1.267A–6(c)(2) for an example illustrating the application of this paragraph (a)(3).

(4) *Payments pursuant to interest-free loans and similar arrangements.* In the case of a specified payment that is interest for U.S. tax purposes, the following special rules apply:

(i) The payment is deemed to be made pursuant to a hybrid transaction to the extent that—

(A) Under U.S. tax law, the payment is imputed (for example, under section 482 or 7872, including because the instrument pursuant to which it is made is indebtedness but the terms of the instrument provide for an interest rate equal to or less than the risk-free rate or the rate on sovereign debt with similar terms in the relevant foreign currency); and

(B) A tax resident or taxable branch to which the payment is made does not take the payment into account in income under its tax law because such tax law does not impute any interest. The rules of paragraph (b)(4) of this section apply for purposes of determining whether the specified payment is made indirectly to a tax resident or taxable branch.

(ii) A tax resident or taxable branch the tax law of which causes the payment to be deemed to be made pursuant to a hybrid transaction under paragraph (a)(4)(i) of this section is deemed to be a specified recipient of the payment for purposes of paragraph (a)(1) of this section.

(b) *Disregarded payments*—(1) *In general*. Subject to §1.267A–3(b) (amounts included or includible in income), the excess (if any) of the sum of a specified party's disregarded payments for a taxable year over its dual inclusion income for the taxable year is a disqualified hybrid amount. See §1.267A–6(c)(3) and (4) for examples illustrating the application of paragraph (b) of this section.

(2) *Definition of disregarded payment*—(i) *In general*. The term *disregarded payment* means a specified payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded (for example, because under such tax law it is a payment involving a single taxpayer or members of a group) and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under such tax law, the tax resident or taxable branch would include the payment in income, as determined under §1.267A–3(a).

(ii) *Special rules*—(A) *Foreign consolidation and similar regimes*. A disregarded payment includes a specified payment that, under the tax law of a tax resident or taxable branch to which the payment is made, is a payment that gives rise to a deduction or similar offset allowed to the tax resident or taxable branch (or group of entities that include the tax resident or taxable branch) under a foreign consolidation, fiscal unity, group relief, loss sharing, or any similar regime.

(B) *Certain payments of a U.S. taxable branch*. In the case of a specified payment of a U.S. taxable branch, the payment is not a disregarded payment to the extent that under the tax law of the tax resident to which the payment is made the payment is otherwise taken into account. See paragraph (c)(2) of this section for an example of when an amount may be otherwise taken into account.

(C) *Coordination with other hybrid and branch arrangements*. A disregarded payment does not include a deemed branch payment described in paragraph (c)(2) of this section, a specified payment pursuant to a repo transaction or similar transaction described in paragraph (a)(3) of this section, or a specified payment pursuant to an interest-free loan or similar transaction described in paragraph (a)(4) of this section.

(3) *Definition of dual inclusion income*—(i) *In general*. With respect to a specified party, the term *dual inclusion income* means the excess, if any, of—

(A) The sum of the specified party's items of income or gain for U.S. tax purposes that are included in the specified party's income, as determined under §1.267A–3(a) (by treating the items of income or gain as the specified payment; and, in the case of a specified party that is a CFC, by treating U.S. tax law as the CFC's tax law), to the extent the items of income or gain are included in the income of the tax resident or taxable branch to which the disregarded payments are made, as determined under §1.267A–3(a) (by treating the items of income or gain as the specified payment); over

(B) The sum of the specified party's items of deduction or loss for U.S. tax purposes (other than deductions for disregarded payments), to the extent the items of deduction or loss are allowable (or have been or will be allowable during a taxable year that ends no more than 36 months after the end of the specified party's taxable year) under the tax law of the tax resident or taxable branch to which the disregarded payments are made.

(ii) *Special rule for certain dividends*. An item of income or gain of a specified party that is included in the specified party's income but not included in the income of the tax resident or taxable branch to which the disregarded payments are made is considered described in paragraph (b)(3)(i)(A) of this section to the extent that, under the tax resident's or taxable branch's tax law, the item is a dividend that would have been included in the income of the tax resident or taxable branch but for an exemption, exclusion, deduction, credit, or other similar relief particular to the item, provided that the party paying the item is not allowed a deduction or other tax benefit for it under its tax law. Similarly, an item of income or gain of a specified party that is included in the income of the tax resident or taxable branch to which the disregarded payments are made but not included in the specified party's income is considered described in paragraph (b)(3)(ii)(A) of this section to the extent that, under U.S. tax law, the item is a dividend that would have been included in the income of the specified party but for a dividends received deduction with respect to the dividend (for example, a deduction under section 245A(a)), provided that the party paying the item is not allowed a deduction or other tax benefit for it under its tax law. See §1.267A–6(c)(3)(iv) for an example illustrating the application of this paragraph (b)(3)(ii).

(4) *Payments made indirectly to a tax resident or taxable branch.* A specified payment made to an entity an interest of which is directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owned by a tax resident or taxable branch is considered made to the tax resident or taxable branch to the extent that, under the tax law of the tax resident or taxable branch, the entity to which the payment is made is fiscally transparent (and all intermediate entities, if any, are also fiscally transparent).

(c) *Deemed branch payments*—(1) *In general.* If a specified payment is a deemed branch payment, then the payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch. See §1.267A–6(c)(4) for an example illustrating the application of this paragraph (c).

(2) *Definition of deemed branch payment.* The term *deemed branch payment* means, with respect to a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, any amount of interest or royalties allowable as a deduction in computing the business profits of the U.S. permanent establishment, to the extent the amount is deemed paid to the home office (or other branch of the home office), is not regarded (or otherwise taken into account) under the home office's tax law (or the other branch's tax law), and, were the payment to be regarded (and treated as interest or a royalty, as applicable) under the home office's tax law (or other branch's tax law), the home office (or other branch) would include the payment in income, as determined under §1.267A–3(a). An amount may be otherwise taken into account for purposes of this paragraph (c)(2) if, for example, under the home office's tax law a corresponding amount of interest or royalties is allocated and attributable to the U.S. permanent establishment and is therefore not deductible.

(d) *Payments to reverse hybrids*—(1) *In general.* If a specified payment is made to a reverse hybrid, then, subject to §1.267A–3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that—

(i) An investor, the tax law of which treats the reverse hybrid as not fiscally transparent, does not include the payment in income, as determined under §1.267A–3(a) (to such extent, a *no-inclusion*); and

(ii) The investor's no-inclusion is a result of the payment being made to the reverse hybrid. For purposes of this paragraph (d)(1)(ii), the investor's no-inclusion is a result of the specified payment being made to the reverse hybrid to the extent that the no-inclusion would not occur were the investor's tax law to treat the reverse hybrid as fiscally transparent (and treat the payment as interest or a royalty, as applicable). See §1.267A–6(c)(5) for an example illustrating the application of paragraph (d) of this section.

(2) *Definition of reverse hybrid.* The term *reverse hybrid* means an entity (regardless of whether domestic or foreign) that is fiscally transparent under the tax law of the country in which it is created, organized, or otherwise established but not fiscally transparent under the tax law of an investor of the entity.

(3) *Payments made indirectly to a reverse hybrid.* A specified payment made to an entity an interest of which is directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owned by a reverse hybrid is considered made to the reverse hybrid to the extent that, under the tax law of an investor of the reverse hybrid, the entity to which the payment is made is fiscally transparent (and all intermediate entities, if any, are also fiscally transparent).

(4) *Exception for inclusion by taxable branch in establishment country.* Paragraph (d)(1) of this section does not apply to a specified payment made to a reverse hybrid to the extent that a taxable branch located in the country in which the reverse hybrid is created, organized, or otherwise established (and the activities of which are carried on by one or more investors of the reverse hybrid) includes the payment in income, as determined under §1.267A–3(a).

(e) *Branch mismatch payments*—(1) *In general.* If a specified payment is a branch mismatch payment, then, subject to §1.267A–3(b) (amounts included or includible in income), the payment is a disqualified hybrid amount to the extent that—

(i) A home office, the tax law of which treats the payment as income attributable to a branch of the home office, does not include the payment in income, as determined under §1.267A–3(a) (to such extent, a *no-inclusion*); and

(ii) The home office's no-inclusion is a result of the payment being a branch mismatch payment. For purposes of this paragraph (e)(1)(ii), the home office's no-inclusion is a result of the specified payment being a branch mismatch payment to the extent that the no-inclusion would not occur were the home office's tax law to treat the payment as income that is not attributable a branch of the home office (and treat the payment as interest or a royalty, as applicable). See §1.267A–6(c)(6) for an example illustrating the application of paragraph (e) of this section.

(2) *Definition of branch mismatch payment.* The term *branch mismatch payment* means a specified payment for which the following requirements are satisfied:

(i) Under a home office's tax law, the payment is treated as income attributable to a branch of the home office; and

(ii) Either—

(A) The branch is not a taxable branch; or

(B) Under the branch's tax law, the payment is not treated as income attributable to the branch.

(f) *Relatedness or structured arrangement limitation.* A specified recipient, a tax resident or taxable branch to which a specified payment is made, an investor, or a home office is taken into account for purposes of paragraphs (a), (b), (d), and (e) of this section, respectively, only if the specified recipient, the tax resident or taxable branch, the investor, or the home office, as applicable, is related (as defined in §1.267A–5(a)(14)) to the specified party or is a party to a structured arrangement (as defined in §1.267A–5(a)(20)) pursuant to which the specified payment is made.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020]

§1.267A–3 Income inclusions and amounts not treated as disqualified hybrid amounts.

(a) *Income inclusions*—(1) *General rule.* For purposes of section 267A, a tax resident or taxable branch includes in income a specified payment to the extent that, under the tax law of the tax resident or taxable branch—

(i) It takes the payment into account (or has taken the payment into account, or, based on all the facts and circumstances, is reasonably expected to take the payment into account during a taxable year that ends no more than 36 months after the end of the specified party's taxable year) in its income or tax base at the full marginal rate imposed on ordinary income (or, if different, the full marginal rate imposed on interest or a royalty, as applicable); and

(ii) The payment is not reduced or offset by an exemption, exclusion, deduction, credit (other than for withholding tax imposed on the payment), or other similar relief particular to such type of payment. Examples of such reductions or offsets include a participation exemption, a dividends received deduction, a deduction or exclusion with respect to a particular category of income (such as income attributable to a branch, or royalties under a patent box regime), a credit for underlying taxes paid by a corporation from which a dividend is received, and a recovery of basis with respect to stock or a recovery of principal with respect to indebtedness. A specified payment is not considered reduced or offset by a deduction or other similar relief particular to the type of payment if it is offset by a generally applicable deduction or other tax attribute, such as a deduction for depreciation or a net operating loss. For purposes of this paragraph (a)(1)(ii), a deduction may be treated as being generally applicable even if it arises from a transaction related to the specified payment (for example, if the deduction and payment are in connection with a back-to-back financing arrangement).

(2) *Coordination with foreign hybrid mismatch rules*. Whether a tax resident or taxable branch includes in income a specified payment is determined without regard to any defensive or secondary rule contained in hybrid mismatch rules, if any, under the tax law of the tax resident or taxable branch. For purposes of this paragraph (a)(2), a defensive or secondary rule means a provision of hybrid mismatch rules that requires a tax resident or taxable branch to include an amount in income if a deduction for the amount is not disallowed under the payer's tax law. However, a defensive or secondary rule does not include a rule pursuant to which a participation exemption or similar relief particular to a dividend is inapplicable as to a dividend for which the payer is allowed a deduction or other tax benefit under its tax law. Thus, a defensive or secondary rule does not include a rule consistent with recommendation 2.1 in Chapter 2 of OECD/G–20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015).

(3) *Inclusions with respect to reverse hybrids*. With respect to a tax resident or taxable branch that is an investor of a reverse hybrid, whether the investor includes in income a specified payment made to the reverse hybrid is determined without regard to a distribution from the reverse hybrid (or the right to a distribution from the reverse hybrid triggered by the payment). However, if the reverse hybrid distributes all of its income during a taxable year, then, for that year, the determination of whether an investor includes in income a specified payment made to the reverse hybrid is made with regard to one or more distributions from the reverse hybrid during the year, by treating a portion of the specified payment as relating to each distribution during the year. For purposes of this paragraph (a)(3), the portion of the specified payment that is considered to relate to a distribution is the lesser of—

(i) The specified payment multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the aggregate amount of distributions from the reverse hybrid during the taxable year; and

(ii) The amount of the distribution multiplied by a fraction, the numerator of which is the specified payment and the denominator of which is the sum of all specified payments made to the reverse hybrid during the taxable year.

(4) *Inclusions with respect to certain payments pursuant to hybrid transactions*. This paragraph (a)(4) applies to a specified payment that is interest and that is made pursuant to a hybrid transaction, to the extent that, under the tax law of a specified recipient of the payment, the payment is a recovery of basis with respect to stock or a recovery of principal with respect to

indebtedness such that, but for this paragraph (a)(4), a no-inclusion would occur with respect to the specified recipient. In such a case, an amount that is a repayment of principal for U.S. tax purposes and that is or has been paid (or, based on all the facts and circumstances, is reasonably expected to be paid) by the specified party pursuant to the hybrid transaction (such amount, the *principal payment*) is, to the extent included in the income of the specified recipient, treated as correspondingly reducing the specified recipient's no-inclusion with respect to the specified payment. For purposes of this paragraph (a)(4), whether the specified recipient includes the principal payment in income is determined under paragraph (a)(1) of this section, by treating the principal payment as the specified payment and the taxable year period described in paragraph (a)(1) as being composed of taxable years of the specified recipient ending no more than 36 months after the end of the specified party's taxable year during which the specified payment is made (as opposed to, for example, being composed of taxable years of the specified recipient ending no more than 36 months after the end of the specified party's taxable year during which the principal payment is reasonably expected to be made). Moreover, once a principal payment reduces a no-inclusion with respect to a specified payment, it is not again taken into account for purposes of applying this paragraph (a)(4) to another specified payment. See §1.267A–6(c)(1)(vi) for an example illustrating the application of this paragraph (a)(4).

(5) *Deemed full inclusions and de minimis inclusions.* A preferential rate, exemption, exclusion, deduction, credit, or similar relief particular to a type of payment that reduces or offsets 90 percent or more of the payment is considered to reduce or offset 100 percent of the payment. In addition, a preferential rate, exemption, exclusion, deduction, credit, or similar relief particular to a type of payment that reduces or offsets 10 percent or less of the payment is considered to reduce or offset none of the payment.

(b) *Certain amounts not treated as disqualified hybrid amounts to extent included or includible in income for U.S. tax purposes*—(1) *In general.* A specified payment, to the extent that but for this paragraph (b) it would be a disqualified hybrid amount (such amount, a *tentative disqualified hybrid amount*), is reduced under the rules of paragraphs (b)(2) through (4) of this section, as applicable. The tentative disqualified hybrid amount, as reduced under such rules, is the disqualified hybrid amount. See §1.267A–6(c)(3) and (7) for examples illustrating the application of paragraph (b) of this section.

(2) *Included in income of United States tax resident or U.S. taxable branch.* A tentative disqualified hybrid amount is reduced to the extent that a specified recipient that is a tax resident of the United States or a U.S. taxable branch takes the tentative disqualified hybrid amount into account in determining its gross income.

(3) *Includible in income under section 951(a)(1)(A).* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount is received by a CFC and includible under section 951(a)(1)(A) (determined without regard to properly allocable deductions of the CFC, qualified deficits under section 952(c)(1)(B), and the earnings and profits limitation under §1.952–1(c)) in the gross income of a United States shareholder of the CFC. However, if the United States shareholder is a domestic partnership, then the amount includible under section 951(a)(1)(A) in the gross income of the United States shareholder reduces the tentative disqualified hybrid amount only to the extent that a tax resident of the United States would take into account the amount.

(4) *Includible in income under section 951A(a).* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount increases a United States shareholder's pro rata share of tested income (as determined under §§1.951A–1(d)(2) and 1.951A–2(b)(1)) with respect to a CFC, reduces the shareholder's pro rata share of tested loss (as determined under §§1.951A–1(d)(4) and 1.951A–2(b)(2)) of the CFC, or both. However, to the extent that a deduction for the tentative disqualified hybrid amount would be allowed to a tax resident of

the United States or a U.S. taxable branch, or would be allowed to a CFC but would be allocated and apportioned to gross income of the CFC that is gross income taken into account in determining subpart F income (as described in section 952) or gross income that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States (as described in §1.882–4(a)(1)), the reduction provided under this paragraph (b)(4) is equal to the reduction that would be provided under this paragraph (b)(4) but for this sentence multiplied by the difference of 100 percent and the percentage described in section 250(a)(1)(B).

(5) *Includible in income under section 1293.* A tentative disqualified hybrid amount is reduced to the extent that the tentative disqualified hybrid amount is received by a qualified electing fund (as described in section 1295) and is includible under section 1293 in the gross income of a United States person that owns stock of that fund. However, if the United States person is a domestic partnership, then the amount includible under section 1293 in the gross income of the United States person reduces the tentative disqualified hybrid amount only to the extent that a tax resident of the United States would take into account the amount.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020]

§ 1.267A–4 Disqualified imported mismatch amounts.

(a) *Disqualified imported mismatch amounts*—(1) *Rule.* An imported mismatch payment is a disqualified imported mismatch amount to the extent that, under the set-off rules of paragraph (c) of this section, the income attributable to the payment is directly or indirectly offset by a hybrid deduction incurred by a foreign tax resident or foreign taxable branch that is related to the imported mismatch payer (or that is a party to a structured arrangement pursuant to which the payment is made). See §1.267A–6(c)(8) through (12) for examples illustrating the application of this section.

(2) *Definitions of certain terms.* The following definitions apply for purposes of this section:

(i) A *foreign tax resident* means a tax resident that is not a tax resident of the United States.

(ii) A *foreign taxable branch* means a taxable branch that is not a U.S. taxable branch.

(iii) An *imported mismatch payee* means, with respect to an imported mismatch payment, a foreign tax resident or foreign taxable branch that includes the payment in income, as determined under §1.267A–3(a).

(iv) An *imported mismatch payer* means, with respect to an imported mismatch payment, the specified party.

(v) An *imported mismatch payment* means a specified payment to the extent that it is neither a disqualified hybrid amount nor included or includible in income in the United States. For purposes of this paragraph (a)(2)(v), a specified payment is included or includible in income in the United States to the extent that, if the payment were a tentative disqualified hybrid amount (as described in §1.267A–3(b)(1)), it would be reduced under the rules of §1.267A–3(b)(2) through (5).

(b) *Hybrid deduction*—(1) *In general.* A *hybrid deduction* means any of the following:

(i) A deduction allowed to a foreign tax resident or foreign taxable branch under its tax law for an amount paid or accrued that is interest (including an amount that would be a structured payment under the principles of §1.267A–5(b)(5)(ii)) or royalty under such tax law, to the extent that a deduction for the amount would be disallowed if such tax law contained rules substantially similar to those under §§1.267A–1 through 1.267A–3 and 1.267A–5. Such a deduction is a hybrid deduction regardless of whether or how the amount giving rise to the deduction would be recognized under U.S. tax law.

(ii) A deduction allowed to a foreign tax resident or foreign taxable branch under its tax law with respect to equity (including deemed equity), such as a notional interest deduction (or similar deduction determined with respect to the foreign tax resident's or foreign taxable branch's equity). However, a deduction allowed to a foreign tax resident or foreign taxable branch with respect to equity is a hybrid deduction only to the extent that an investor of the foreign tax resident, or the home office of the foreign taxable branch, would include the amount in income if, for purposes of the investor's or home office's tax law, the amount were interest paid by the foreign tax resident ratably (by value) with respect to the interests of the foreign tax resident, or interest paid by the foreign taxable branch to the home office. For purposes of this paragraph (b)(1)(ii), the rules of §1.267A–3(a) apply to determine the extent that an investor or home office would include an amount in income, by treating the amount as the specified payment.

(2) *Special rules*—(i) *Foreign tax law contains hybrid mismatch rules.* In the case of a foreign tax resident or foreign taxable branch the tax law of which contains hybrid mismatch rules, only the following deductions allowed to the foreign tax resident or foreign taxable branch under its tax law are hybrid deductions:

(A) A deduction described in paragraph (b)(1)(i) of this section, to the extent that the deduction would be disallowed if the foreign tax resident's or foreign taxable branch's tax law—

(*1*) Contained a rule substantially similar to §1.267A–2(a)(4) (payments pursuant to interest-free loans and similar arrangements); or

(*2*) Did not permit an inclusion in income in a third country to discharge the application of its hybrid mismatch rules as to the amount giving rise to the deduction when the amount is not included in income in another country as a result of a hybrid or branch arrangement.

(B) A deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity).

(ii) *Dual inclusion income used to determine hybrid deductions arising from deemed branch payments in certain cases.* In the case of a foreign taxable branch the tax law of which permits a loss of the foreign taxable branch to be shared with a tax resident or taxable branch (without regard to whether it is in fact so shared or whether there is a tax resident or taxable branch with which the loss can be shared), a deduction allowed to the foreign taxable branch for an amount that would be a deemed branch payment were such tax law to contain a provision substantially similar to §1.267A–2(c) is a hybrid deduction to the extent of the excess (if any) of the sum of all such amounts over the foreign taxable branch's dual inclusion income (as determined under the principles of §1.267A–2(b)(3)). The rule in this paragraph (b)(2)(ii) applies without regard to whether the tax law of the home office provides an exclusion or exemption for income attributable to the branch.

(iii) *Certain deductions are hybrid deductions only if allowed for an accounting period beginning on or after December 20, 2018.* A deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity), or a deduction that would be disallowed if the foreign tax resident's or foreign taxable branch's tax law contained a rule substantially similar to §1.267A–2(a)(4) (payments pursuant to interest-free loans and similar arrangements), is a hybrid deduction only if allowed for an accounting period beginning on or after December 20, 2018.

(iv) *Certain deductions of a CFC are not hybrid deductions.* A deduction that but for this paragraph (b)(2)(iv) would be a hybrid deduction is not a hybrid deduction to the extent that the amount paid or accrued giving rise to the deduction is—

(A) A disqualified hybrid amount (but subject to the special rule of paragraph (g) of this section); or

(B) Included or includible in income in the United States. For purposes of this paragraph (b)(2)(iv)(B), an amount is included or includible in income in the United States to the extent that, if the amount were a tentative disqualified hybrid amount (as described in §1.267A–3(b)(1)), it would be reduced under the rules of §1.267A–3(b)(2) through (5).

(v) *Loss carryovers.* A hybrid deduction for a particular accounting period includes a loss carryover from another accounting period, but only to the extent that a hybrid deduction incurred in an accounting period ending on or after December 20, 2018, comprises the loss carryover.

(c) *Set-off rules*—(1) *In general.* In the order described in paragraph (c)(2) of this section, a hybrid deduction directly or indirectly offsets the income attributable to an imported mismatch payment to the extent that, under paragraph (c)(3) of this section, the payment directly or indirectly funds the hybrid deduction. The rules of paragraphs (c)(2) and (3) of this section are applied by taking into account the application of paragraph (c)(4) of this section (adjustments to ensure that amounts not taken into account more than once).

(2) *Ordering rules.* The following ordering rules apply for purposes of determining the extent that a hybrid deduction directly or indirectly offsets income attributable to imported mismatch payments.

(i) First, the hybrid deduction offsets income attributable to a factually-related imported mismatch payment that directly or indirectly funds the hybrid deduction. For purposes of this paragraph (c)(2)(i), a *factually-related imported mismatch payment* means an imported mismatch payment that is made pursuant to a transaction, agreement, or instrument entered into pursuant to the same plan or series of related transactions that includes the transaction, agreement, or instrument pursuant to which the hybrid deduction is incurred, provided that a design of the plan or series of related transactions was for the hybrid deduction to offset income attributable to the payment (as determined under the principles of §1.267A–5(a)(20)(i), by treating the offset as the "hybrid mismatch" described in §1.267A–5(a)(20)(i)).

(ii) Second, to the extent remaining, the hybrid deduction offsets income attributable to an imported mismatch payment (other than a factually-related imported mismatch payment) that directly funds the hybrid deduction.

(iii) Third, to the extent remaining, the hybrid deduction offsets income attributable to an imported mismatch payment (other than a factually-related imported mismatch payment) that indirectly funds the hybrid deduction.

(3) *Funding rules.* The following funding rules apply for purposes of determining the extent that an imported mismatch payment directly or indirectly funds a hybrid deduction.

(i) The imported mismatch payment directly funds a hybrid deduction to the extent that the imported mismatch payee incurs the hybrid deduction.

(ii) The imported mismatch payment indirectly funds a hybrid deduction to the extent that the imported mismatch payee is allocated the hybrid deduction, and provided that the imported mismatch payee is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the imported mismatch payment is made).

(iii) The imported mismatch payee is allocated a hybrid deduction to the extent that the imported mismatch payee directly or indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(iv) An imported mismatch payee indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction to the extent that a chain of funded taxable payments connects the imported mismatch payee, each intermediary foreign tax resident or foreign taxable branch, and the foreign tax resident or foreign taxable branch that incurs the hybrid deduction, and provided that each intermediary foreign tax resident or foreign taxable branch is related to the imported mismatch payer (or is a party to a structured arrangement pursuant to which the imported mismatch payment is made).

(v) The term *funded taxable payment* means an amount paid or accrued by a foreign tax resident or foreign taxable branch under its tax law (other than an amount that gives rise to a hybrid deduction), to the extent that—

(A) The amount is deductible (but, if such tax law contains hybrid mismatch rules, determined without regard to a provision substantially similar to this section);

(B) Another foreign tax resident or foreign taxable branch includes the amount in income, as determined under §1.267A–3(a) (by treating the amount as the specified payment); and

(C) The amount is neither a disqualified hybrid amount (but subject to the special rule of paragraph (g) of this section) nor included or includible in income in the United States. For purposes of this paragraph (c)(3)(v)(C), an amount is included or includible in income in the United States to the extent that, if the amount were a tentative disqualified hybrid amount (as described in §1.267A–3(b)(1)), it would be reduced under the rules of §1.267A–3(b)(2) through (5).

(vi) If a deduction or loss that is not incurred by a foreign tax resident or foreign taxable branch is directly or indirectly made available to offset income of the foreign tax resident or foreign taxable branch under its tax law, then, for purposes of this paragraph (c), the foreign tax resident or foreign taxable branch to which the deduction or loss is made available and the foreign tax resident or foreign taxable branch that incurs the deduction or loss are treated as a single foreign tax resident or foreign taxable branch. For example, if a deduction or loss of one foreign tax resident is made available to offset income of another foreign tax resident under a tax consolidation, fiscal unity, group relief, loss sharing, or any similar regime, then the foreign tax residents are treated as a single foreign tax resident for purposes of this paragraph (c).

(vii) An imported mismatch payee that directly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction is allocated the hybrid deduction before the hybrid deduction (to the extent remaining) is allocated to an imported mismatch payee that indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(viii) An imported mismatch payee that, through a chain of funded taxable payments consisting of a particular number of funded taxable payments, indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs a hybrid deduction is allocated the hybrid deduction before the hybrid deduction (to the extent remaining) is allocated to an imported mismatch payee that, through a chain of funded taxable payments consisting of a greater number of funded taxable payments, indirectly makes a funded taxable payment to the foreign tax resident or foreign taxable branch that incurs the hybrid deduction.

(4) *Adjustments to ensure amounts not taken into account more than once.* To the extent that the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, the imported mismatch payment, the hybrid deduction, and, if applicable, each funded taxable payment comprising the chain of funded taxable payments connecting the imported mismatch payee, each intermediary foreign tax resident or foreign taxable branch, and the foreign tax resident or foreign taxable branch that incurs the hybrid deduction is correspondingly reduced; as a result, such amounts are not again taken into account under this section.

(d) *Calculations based on aggregate amounts during accounting period.* For purposes of this section, amounts are determined on an accounting period basis. Thus, for example, the amount of imported mismatch payments made by an imported mismatch payer to a particular imported mismatch payee is equal to the aggregate amount of all such payments made by the imported mismatch payer during the accounting period.

(e) *Pro rata adjustments.* Amounts are allocated on a pro rata basis if there would otherwise be more than one permissible manner in which to allocate the amounts. Thus, for example, if multiple imported mismatch payers make an imported mismatch payment to a single imported mismatch payee, the sum of such payments exceeds the hybrid deduction incurred by the imported mismatch payee, and the payments are not factually-related imported mismatch payments, then a pro rata portion of each imported mismatch payer's payment is considered to directly fund the hybrid deduction. See §1.267A–6(c)(9) and (12) for examples illustrating the application of this paragraph (e).

(f) *Special rules regarding manner in which this section is applied*—(1) *Initial application of this section.* This section is first applied without regard to paragraph (f)(2) of this section and by taking into account only the following hybrid deductions:

(i) A hybrid deduction described in paragraph (b)(1)(i) of this section, to the extent that—

(A) The deduction would be disallowed if the foreign tax resident's or foreign taxable branch's tax law contained a rule substantially similar to §1.267A–2(a)(4) (payments pursuant to interest-free loans and similar arrangements); or

(B) The paid or accrued amount giving rise to the deduction is included in income in a third country but is not included in income in another country as a result of a hybrid or branch arrangement.

(ii) A hybrid deduction described in paragraph (b)(1)(ii) of this section (deductions with respect to equity).

(2) *Subsequent application of this section takes into account certain amounts deemed to be imported mismatch payments.* After this section is applied pursuant to the rules of paragraph (f)(1) of this section, the section is then applied by taking into account only hybrid deductions other than those described in paragraph (f)(1) of this section. In addition, when applying this section in the manner described in the previous sentence, for purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, an amount paid or accrued by a foreign tax resident or foreign taxable branch that is not a specified party is deemed to be an imported mismatch payment (and such foreign tax resident or foreign taxable branch and a foreign tax resident or foreign taxable branch that includes the amount in income, as determined under §1.267A–3(a), by treating the amount as the specified payment, are deemed to be an imported mismatch payer and an imported mismatch payee, respectively) to the extent that—

(i) The tax law of such foreign tax resident or foreign taxable branch contains hybrid mismatch rules; and

(ii) The amount is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to this section. See §1.267A–6(c)(10) and (12) for examples illustrating the application of paragraph (f)(2) of this section.

(g) *Special rule regarding extent to which a disqualified hybrid amount of a CFC prevents a hybrid deduction or a funded taxable payment.* A disqualified hybrid amount of a CFC is taken into account for purposes of paragraph (b)(2)(iv)(A) or (c)(3)(v)(C) of this section (certain deductions not hybrid deductions or funded taxable payments to the extent the amount giving rise to the deduction is a disqualified hybrid amount) only to the extent of the excess (if any) of the disqualified hybrid amount over the sum of the amounts described in paragraphs (g)(1) through (3) of this section. See §1.267A–6(c)(11) for an example illustrating the application of this paragraph (g).

(1) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned to residual CFC gross income (as described in §1.951A–2(c)(5)(iii)(B)) of the CFC.

(2) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned (under the rules of section 954(b)(5)) to gross income that is taken into account in determining the CFC's subpart F income (as described in section 952 and §1.952–1), multiplied by the difference of 100 percent and the percentage of stock (by value) of the CFC that, for purposes of sections 951 and 951A, is owned (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) by one or more tax residents of the United States that are United States shareholders of the CFC.

(3) The disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned (under the rules of §1.951A–2(c)(3)) to gross tested income of the CFC (as described in section 951A(c)(2)(A) and §1.951A–2(c)(1)), multiplied by the difference of 100 percent and the percentage of stock (by value) of the CFC that, for purposes of sections 951 and 951A, is owned (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) by one or more tax

residents of the United States that are United States shareholders of the CFC.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020]

§ 1.267A–5 Definitions and special rules.

(a) *Definitions.* For purposes of §§ 1.267A–1 through 1.267A–7 the following definitions apply.

(1) The term *accounting period* means a taxable year, or a period of similar length over which, under a provision of hybrid mismatch rules substantially similar to § 1.267A–4, computations similar to those under § 1.267A–4 are made under a foreign tax law.

(2) The term *branch* means a taxable presence of a tax resident in a country other than its country of residence as determined under either the tax resident's tax law or such other country's tax law.

(3) The term *branch mismatch payment* has the meaning provided in § 1.267A–2(e)(2).

(4) The term *controlled foreign corporation* (or *CFC*) has the meaning provided in section 957.

(5) The term *deemed branch payment* has the meaning provided in § 1.267A–2(c)(2).

(6) The term *disregarded payment* has the meaning provided in § 1.267A–2(b)(2).

(7) The term *entity* means any person as described in section 7701(a)(1), including an entity that under §§ 301.7701–1 through 301.7701–3 of this chapter is disregarded as an entity separate from its owner, other than an individual.

(8) The term *fiscally transparent* means, with respect to an entity, fiscally transparent with respect to an item of income as determined under the principles of § 1.894–1(d)(3)(ii) and (iii), without regard to whether a tax resident (either the entity or interest holder in the entity) that derives the item of income is a resident of a country that has an income tax treaty with the United States. In addition, the following special rules apply with respect to an item of income received by an entity:

(i) The entity is fiscally transparent with respect to the item under the tax law of the country in which the entity is created, organized, or otherwise established if, under that tax law, the entity does not take the item into account in its income (without regard to whether such tax law requires an investor of the entity, wherever resident, to separately take into account on a current basis the investor's respective share of the item), and the effect under that tax law is that an investor of the entity is required to take the item into account in its income as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(ii) The entity is fiscally transparent with respect to the item under the tax law of an investor of the entity if, under that tax law, an investor of the entity takes the item into account in its income (without regard to whether such tax law requires the investor to separately take into account on a current basis the investor's respective share of the item) as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(iii) The entity is fiscally transparent with respect to the item under the tax law of the country in which the entity is created, organized, or otherwise established if—

(A) That tax law imposes a corporate income tax; and

(B) Under that tax law, neither the entity is required to take the item into account in its income nor an investor of the entity is required to take the item into account in its income as if the item were realized directly from the source from which realized by the entity, whether or not distributed.

(9) The term *home office* means a tax resident that has a branch.

(10) The term *hybrid mismatch rules* means rules, regulations, or other tax guidance substantially similar to section 267A, and includes rules the purpose of which is to neutralize the deduction/no-inclusion outcome of hybrid and branch mismatch arrangements. Examples of such rules would include rules based on, or substantially similar to, the recommendations contained in OECD/G–20, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* (October 2015), and OECD/G–20, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS* (July 2017).

(11) The term *hybrid transaction* has the meaning provided in § 1.267A–2(a)(2).

(12) The term *interest* means any amount described in paragraph (a)(12)(i) or (ii) of this section that is paid or accrued, or treated as paid or accrued, for the taxable year or that is otherwise designated as interest expense in paragraph (a)(12)(i) or (ii) of this section.

(i) *In general*. Interest is an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275–1(d), and not treated as stock under § 1.385–3, or an amount that is treated as interest under other provisions of the Internal Revenue Code (Code) or the regulations in this part. Thus, interest includes, but is not limited to, the following—

(A) Original issue discount (OID);

(B) Qualified stated interest, as adjusted by the issuer for any bond issuance premium;

(C) OID on a synthetic debt instrument arising from an integrated transaction under § 1.1275–6;

(D) Repurchase premium to the extent deductible by the issuer under § 1.163–7(c);

(E) Deferred payments treated as interest under section 483;

(F) Amounts treated as interest under a section 467 rental agreement;

(G) Forgone interest under section 7872;

(H) De minimis OID taken into account by the issuer;

(I) Amounts paid in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles;

(J) Redeemable ground rent treated as interest under section 163(c); and

(K) Amounts treated as interest under section 636.

(ii) *Swaps with significant nonperiodic payments*—(A) *In general*. Except as provided in paragraphs (a)(12)(ii)(B) and (C) of this section, a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan, determined in accordance with § 1.446–3(f)(2)(iii)(A), is recognized as interest expense to the payor.

(B) *Exception for cleared swaps*. Paragraph (a)(12)(ii)(A) of this section does not apply to a cleared swap. The term *cleared swap* means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.

(C) *Exception for non-cleared swaps subject to margin or collateral requirements*. Paragraph (a)(12)(ii)(A) of this section does not apply to a non-cleared swap that requires the parties to meet the margin or collateral requirements of a Federal regulator or that provides for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a Federal regulator. For purposes of this paragraph (a)(12)(ii)(C), the term *Federal regulator* means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII.

(13) The term *investor* means, with respect to an entity, any tax resident or taxable branch that directly or indirectly (determined under the rules of section 958(a) without regard to whether an intermediate entity is foreign or domestic, or under substantially similar rules under a tax resident's or taxable branch's tax law) owns an interest in the entity.

(14) The term *related* has the meaning provided in this paragraph (a)(14). A tax resident or taxable branch is related to a specified party if the tax resident or taxable branch is a related person within the meaning of section 954(d)(3), determined by treating the specified party as the ''controlled foreign corporation'' referred to in section 954(d)(3) and the tax resident or taxable branch as the ''person'' referred to in section 954(d)(3). In addition, for the purposes of this paragraph (a)(14), a tax resident that under §§ 301.7701–1 through 301.7701–3 of this chapter is disregarded as an entity separate from its owner for U.S. tax purposes, as well as a taxable branch, is treated as a corporation. *See also* § 1.954–1(f)(2)(iv)(B)(*1*) (neither section 318(a)(3), nor § 1.958–2(d) or the principles thereof, applies to attribute stock or other interests).

(15) The term *reverse hybrid* has the meaning provided in § 1.267A–2(d)(2).

(16) The term *royalty* includes amounts paid or accrued as consideration for the use of, or the right to use—

(i) Any copyright, including any copyright of any literary, artistic, scientific or other work (including cinematographic films and software);

(ii) Any patent, trademark, design or model, plan, secret formula or process, or other similar property (including goodwill); or

(iii) Any information concerning industrial, commercial or scientific experience, but does not include—

(A) Amounts paid or accrued for after-sales services;

(B) Amounts paid or accrued for services rendered by a seller to the purchaser under a warranty;

(C) Amounts paid or accrued for pure technical assistance; or

(D) Amounts paid or accrued for an opinion given by an engineer, lawyer or accountant.

(17) The term *specified party* means a tax resident of the United States, a CFC (other than a CFC with respect to which there is not a tax resident of the United States that, for purposes of sections 951 and 951A, owns (within the meaning of section 958(a), and determined by treating a domestic partnership as foreign) at least ten percent (by vote or value) of the stock of the CFC), and a U.S. taxable branch. Thus, an entity that is fiscally transparent for U.S. tax purposes is not a specified party, though an owner of the entity may be a specified party. For example, in the case of a payment by a partnership, a domestic corporation that is a partner of the partnership is a specified party and a deduction for its allocable share of the payment is subject to disallowance under section 267A.

(18) The term *specified payment* has the meaning provided in § 1.267A–1(b).

(19) The term *specified recipient* means, with respect to a specified payment, any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law (or any tax resident that, based on all the facts and circumstances, is reasonably expected to derive the payment under its tax law, or any taxable branch to which, based on all the facts and circumstances, the payment is reasonably expected to be attributable under its tax law). The principles of § 1.894–1(d)(1) apply for purposes of determining whether a tax resident derives (or is reasonably expected to derive) a specified payment under its tax law, without regard to whether the tax resident is a resident of a country that has an income tax treaty with the United States. There may be more than one specified recipient with respect to a specified payment.

(20) The terms *structured arrangement* and *party to a structured arrangement* have the meaning set forth in this paragraph (a)(20).

(i) *Structured arrangement.* A structured arrangement means an arrangement with respect to which one or more specified payments would be a disqualified hybrid amount (or a disqualified imported mismatch amount) without regard to the relatedness limitation in § 1.267A–2(f) (or without regard to the phrase ''that is related to the specified party'' in § 1.267A–4(a)) (either such outcome, a *hybrid mismatch*), provided that, based on all the facts and circumstances (including the terms of the arrangement), the arrangement is designed to produce the hybrid mismatch. Facts and circumstances that indicate the arrangement is designed to produce the hybrid mismatch include the following:

(A) The hybrid mismatch is priced into the terms of the arrangement, including—

(*1*) The pricing of the arrangement is different from what the pricing would have been absent the hybrid mismatch;

(*2*) Features that alter the terms of the arrangement, including its return if the hybrid mismatch is no longer available; or

(*3*) A below-market return absent the tax effects or benefits resulting from the hybrid mismatch.

(B) The arrangement is marketed as tax-advantaged where some or all of the tax advantage derives from the hybrid mismatch.

(C) The arrangement is marketed to tax residents of a country the tax law of which enables the hybrid mismatch.

(ii) *Party to a structured arrangement.* A party to a structured arrangement means a tax resident, a taxable branch, or an entity that participates in the structured arrangement. For purposes of this paragraph (a)(20)(ii), in the case of an entity, the entity's participation in a structured arrangement is imputed to its investors. However, a tax resident, a taxable branch or an entity (the *relevant party*) is considered to participate in the structured arrangement only if—

(A) The relevant party (or a related tax resident or taxable branch, determined under paragraph (a)(14) of this section by treating the relevant party as a specified party) could, based on all the facts and circumstances, reasonably be expected to be aware of the hybrid mismatch; and

(B) The relevant party or one or more of its investors (or a related tax resident or taxable branch, determined under paragraph (a)(14) of this section by treating the relevant party or an investor as a specified party) shares in the value of the tax benefit resulting from the hybrid mismatch.

(21) The term *tax law* of a country includes statutes, regulations, administrative or judicial rulings, and income tax treaties of the country. If a country has an income tax treaty with the United States that applies to taxes imposed by a political subdivision or other local authority of that country, then the tax law of the political subdivision or other local authority is deemed to be a tax law of a country. When used with respect to a tax resident or branch, tax law refers to—

(i) In the case of a tax resident, the tax law of the country or countries where the tax resident is resident; and

(ii) In the case of a branch, the tax law of the country where the branch is located.

(22) The term *taxable branch* means a branch that has a taxable presence under its tax law.

(23) The term *tax resident* means either of the following:

(i) A body corporate or other entity or body of persons liable to tax under the tax law of a country as a resident. For purposes of this paragraph (a)(23)(i), an entity that is created, organized, or otherwise established under the tax law of a country that does not impose a corporate income tax is treated as liable to tax under the tax law of such country as a resident if under the corporate or commercial laws of such country the entity is treated as a body corporate or a company. A body corporate or other entity or body of persons may be a tax resident of more than one country.

(ii) An individual liable to tax under the tax law of a country as a resident. An individual may be a tax resident of more than one country.

(24) The term *United States shareholder* has the meaning provided in section 951(b).

(25) The term *U.S. taxable branch* means a trade or business carried on in the United States by a tax resident of another country, except that if an income tax treaty applies, the term means a permanent establishment of a tax treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country. Thus, for example, a U.S. taxable branch includes a U.S. trade or business of a foreign corporation taxable under section 882(a) or a U.S. permanent establishment of a tax treaty resident.

(b) *Special rules.* For purposes of §§ 1.267A–1 through 1.267A–7, the following special rules apply.

(1) *Coordination with other provisions*—(i) *In general.* Except as provided in

paragraph (b)(1)(ii) of this section, a specified payment is subject to section 267A after the application of any other applicable provisions of the Code and regulations in this part. Thus, the determination of whether a deduction for a specified payment is disallowed under section 267A is made with respect to the taxable year for which a deduction for the payment would otherwise be allowed for U.S. tax purposes. *See, for example,* sections 163(e)(3) and 267(a)(3) for rules that may defer the taxable year for which a deduction is allowed. *See also* §1.882–5(a)(5) (providing that provisions that disallow interest expense apply after the application of §1.882–5). In addition, provisions that characterize amounts paid or accrued as something other than interest or royalties, such as §1.894–1(d)(2), govern the treatment of such amounts and therefore such amounts would not be treated as specified payments. Moreover, to the extent that a specified payment is not described in §1.267A–1(b) when it is subject to section 267A, the payment is not again subject to section 267A at a later time. For example, if for the taxable year in which a specified payment is paid the payment is not described in §1.267A–1(b) but under section 163(j) a deduction for the payment is deferred, the payment is not again subject to section 267A in the taxable year for which section 163(j) no longer defers the deduction.

(ii) *Section 267A applied before certain provisions.* In addition to the extent provided in any other applicable provision of the Code or regulations in this part, section 267A applies before the application of sections 163(j), 461(l), 465, and 469.

(iii) *Coordination with capitalization and recovery provisions.* To the extent a specified payment is described in §1.267A–1(b), a deduction for the payment is considered permanently disallowed for all purposes of the Code and regulations in this part and, therefore, the payment is not taken into account for purposes of computing costs that are required to be capitalized and recovered through depreciation, amortization, cost of goods sold, adjustment to basis, or similar forms of recovery under any applicable provision of the Code or in regulations in this part. Thus, for example, to the extent an interest or royalty payment is a specified payment described in §1.267A–1(b), the payment is not capitalized and included in inventory cost or added to basis under section 263A. As an additional example, to the extent that a debt issuance cost is a specified payment described in §1.267A–1(b), it is neither capitalized under section 263 or the regulations in this part under section 263 nor recoverable under §1.446–5.

(iv) *Specified payments arising in taxable years beginning before January 1, 2018.* Section 267A does not apply to a specified payment that is paid or accrued in a taxable year beginning before January 1, 2018, regardless of whether under a provision of the Code or regulations in this part (for example, section 267(a)(3)) a deduction for the payment is deferred to a taxable year beginning after December 31, 2017, or whether the payment is carried over to another taxable year and under another provision of the Code (for example, section 163(j)) is considered paid or accrued in such taxable year.

(2) *Foreign currency gain or loss.* Except as set forth in this paragraph (b)(2), section 988 gain or loss is not taken into account under section 267A. Foreign currency gain or loss recognized with respect to a specified payment is taken into account under section 267A to the extent that a deduction for the specified payment is disallowed under section 267A, provided that the foreign currency gain or loss is described in §1.988–2(b)(4) (relating to exchange gain or loss recognized by the issuer of a debt instrument with respect to accrued interest) or §1.988–2(c) (relating to items of expense or gross income or receipts which are to be paid after the date accrued). If a deduction for a specified payment is disallowed under section 267A, then a proportionate amount of foreign currency loss under section 988 with respect to the specified payment is also disallowed, and a proportionate amount of foreign currency gain under section 988 with respect to the specified payment reduces the amount of the disallowance. For purposes of this paragraph (b)(2), the proportionate amount is the amount of the foreign currency gain or loss under section 988 with respect to

the specified payment multiplied by a fraction, the numerator of which is the amount of the specified payment for which a deduction is disallowed under section 267A and the denominator of which is the total amount of the specified payment.

(3) *U.S. taxable branch payments*—(i) *Amounts considered paid or accrued by a U.S. taxable branch*. For purposes of section 267A, a U.S. taxable branch is considered to pay or accrue an amount of interest or royalty equal to either—

(A) The amount of interest or royalty allocable to effectively connected income of the U.S. taxable branch under section 873(a) or 882(c)(1), as applicable; or

(B) In the case of a U.S. taxable branch that is a U.S. permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the United States and the treaty country, the amount of interest or royalty allowable in computing the business profits attributable to the U.S. permanent establishment.

(ii) *Treatment of U.S. taxable branch payments*—(A) *Interest*. Interest considered paid or accrued by a U.S. taxable branch of a foreign corporation under paragraph (b)(3)(i) of this section (the ''U.S. taxable branch interest payment'') is treated as a payment directly to the person to which the interest is payable, to the extent it is paid or accrued with respect to a liability described in §1.882–5(a)(1)(ii)(A) or (B) (resulting in directly allocable interest) or with respect to a U.S. booked liability, as described in §1.882–5(d)(2). If the U.S. taxable branch interest payment exceeds in the aggregate the interest paid or accrued on the U.S. taxable branch's directly allocable interest and interest paid or accrued on U.S. booked liabilities, the excess amount is treated as paid or accrued by the U.S. taxable branch on a pro-rata basis to the same persons and pursuant to the same terms that the home office paid or accrued interest, excluding any directly allocable interest or interest paid or accrued on a U.S. booked liability. The rules of this paragraph (b)(3)(ii) for determining to whom interest is paid or accrued apply without regard to whether the U.S. taxable branch interest payment is determined under the method described in §1.882–5(b) through (d) or the method described in §1.882–5(e).

(B) *Royalties*. Royalties considered paid or accrued by a U.S. taxable branch under paragraph (b)(3)(i) of this section are treated solely for purposes of section 267A as paid or accrued on a pro-rata basis by the U.S. taxable branch to the same persons and pursuant to the same terms that the home office paid or accrued such royalties.

(C) *Permanent establishments and interbranch payments*. If a U.S. taxable branch is a permanent establishment in the United States, the principles of the rules in paragraphs (b)(3)(ii)(A) and (B) of this section apply with respect to interest and royalties allowed in computing the business profits of a treaty resident eligible for treaty benefits. This paragraph (b)(3)(ii)(C) does not apply to interbranch interest or royalty payments allowed as deduction under certain U.S. income tax treaties (as described in §1.267A–2(c)(2)).

(4) *Effect on earnings and profits*. The disallowance of a deduction under section 267A does not affect whether the amount paid or accrued that gave rise to the deduction reduces earnings and profits of a corporation. However, for purposes of section 952(c)(1) and §1.952–1(c), a CFC's earnings and profits are not reduced by a specified payment a deduction for which is disallowed under section 267A, if a principal purpose of the transaction pursuant to which the payment is made is to reduce or limit the CFC's subpart F income.

(5) *Application to structured payments*—(i) *In general*. For purposes of section 267A and the regulations in this part under section 267A, a structured payment (as defined in paragraph (b)(5)(ii) of this section) is treated as interest. Thus, a structured payment is treated as subject to section 267A and the regulations in this part under section 267A to the same extent as if the payment were an amount of interest paid or accrued.

(ii) *Structured payment*. A structured payment means any amount described in paragraph (b)(5)(ii)(A) or (B) of this section.

(A) *Substitute interest payments*. A substitute interest payment described in §1.861–2(a)(7) is treated as a structured payment for purposes of section 267A, unless the payment relates to a sale-repurchase agreement or a securities lending transaction that is entered into by the payor in the ordinary course of the payor's business. This paragraph (b)(5)(ii)(A) does not apply to an amount described in paragraph (a)(12)(i)(I) of this section.

(B) *Amounts economically equivalent to interest*—(*1*) *Principal purpose to reduce interest expense*. Any expense or loss economically equivalent to interest is treated as a structured payment for purposes of section 267A if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (a)(12) or (b)(5)(ii)(A) of this section. For purposes of this paragraph (b)(5)(ii)(B)(*1*), the fact that the taxpayer has a business purpose for obtaining the use of funds does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. In addition, the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. For purposes of this paragraph (b)(5)(ii)(B), any expense or loss is economically equivalent to interest to the extent that the expense or loss is—

(*i*) Deductible by the taxpayer;

(*ii*) Incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time;

(*iii*) Substantially incurred in consideration of the time value of money; and

(*iv*) Not described in paragraph (a)(12) or (b)(5)(ii)(A) of this section.

(*2*) *Principal purpose*. Whether a transaction or a series of integrated or related transactions is entered into with a principal purpose described in paragraph (b)(5)(ii)(B)(*1*) of this section depends on all the facts and circumstances related to the transaction(s). A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction(s) include the taxpayer's normal borrowing rate in the taxpayer's functional currency, whether the taxpayer would enter into the transaction(s) in the ordinary course of the taxpayer's trade or business, whether the parties to the transaction(s) are related persons (within the meaning of section 267(b) or 707(b)), whether there is a significant and bona fide business purpose for the structure of the transaction(s), whether the transactions are transitory, for example, due to a circular flow of cash or other property, and the substance of the transaction(s).

(6) *Anti-avoidance rule*. A specified party's deduction for a specified payment is disallowed to the extent that both of the following requirements are satisfied:

(i) The payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, as determined under §1.267A–3(a) (but without regard to the deemed full inclusion rule in §1.267A–3(a)(5)).

(ii) A principal purpose of the terms or structure of the arrangement (including the form and the tax laws of the parties to the arrangement) is to avoid the application of the regulations in this part under section 267A in a manner that is contrary to the purposes of section 267A and the regulations in this part under section 267A.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020, as amended by 85 FR 48651, Aug. 12, 2020]

§ 1.267A–6 Examples.

(a) *Scope*. This section provides examples that illustrate the application of §§1.267A–1 through 1.267A–5.

(b) *Presumed facts*. For purposes of the examples in this section, unless otherwise indicated, the following facts are presumed:

(1) US1, US2, and US3 are domestic corporations that are tax residents solely of the United States.

(2) FW, FX, and FZ are bodies corporate established in, and tax residents of, Country W, Country X, and Country

Z, respectively. They are not fiscally transparent under the tax law of any country. They are not specified parties.

(3) Under the tax law of each country, interest and royalty payments are deductible.

(4) The tax law of each country provides a 100 percent participation exemption for dividends received from non-resident corporations.

(5) The tax law of each country, other than the United States, provides an exemption for income attributable to a branch.

(6) Except as provided in paragraphs (b)(4) and (5) of this section, all amounts derived (determined under the principles of §1.894–1(d)(1)) by a tax resident, or attributable to a taxable branch, are included in income, as determined under §1.267A–3(a).

(7) Only the tax law of the United States contains hybrid mismatch rules.

(c) *Examples*—(1) *Example 1. Payment pursuant to a hybrid financial instrument*—(i) *Facts*. FX holds all the interests of US1. FX also holds an instrument issued by US1 that is treated as equity for Country X tax purposes and indebtedness for U.S. tax purposes (the FX–US1 instrument). On date 1, US1 pays $50x to FX pursuant to the instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for U.S. tax purposes.

(ii) *Analysis*. US1 is a specified party and thus a deduction for its $50x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(1)(ii)(A) through (C) of this section, the entire $50x payment is a disqualified hybrid amount under the hybrid transaction rule of §1.267A–2(a) and, as a result, a deduction for the payment is disallowed under §1.267A–1(b)(1).

(A) US1's payment is made pursuant to a hybrid transaction because a payment with respect to the FX–US1 instrument is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1). *See* §1.267A–2(a)(2) and (f). Therefore, §1.267A–2(a) applies to the payment.

(B) For US1's payment to be a disqualified hybrid amount under §1.267A–2(a), a no-inclusion must occur with respect to FX. *See* §1.267A–2(a)(1)(i). As a consequence of the Country X participation exemption, FX includes $0 of the payment in income and therefore a $50x no-inclusion occurs with respect to FX. *See* §1.267A–3(a)(1). The result is the same regardless of whether, under the Country X participation exemption, the $50x payment is simply excluded from FX's taxable income or, instead, is reduced or offset by other means, such as a $50x dividends received deduction. *See* §1.267A–3(a)(1).

(C) Pursuant to §1.267A–2(a)(1)(ii), FX's $50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being made pursuant to the hybrid transaction. FX's $50x no-inclusion is a result of the payment being made pursuant to the hybrid transaction because, were the payment to be treated as interest for Country X tax purposes, FX would include $50x in income and, consequently, the no-inclusion would not occur.

(iii) *Alternative facts—multiple specified recipients*. The facts are the same as in paragraph (c)(1)(i) of this section, except that FX holds all the interests of FZ, which is fiscally transparent for Country X tax purposes, and FZ holds all of the interests of US1. Moreover, the FX–US1 instrument is held by FZ (rather than by FX) and US1 makes its $50x payment to FZ (rather than to FX); the payment is derived by FZ under its tax law and by FX under its tax law and, accordingly, both FZ and FX are specified recipients of the payment. Further, the payment is treated as interest for Country Z tax purposes and FZ includes it in income. For the reasons described in paragraph (c)(1)(ii) of this section, FX's no-inclusion causes the payment to be a disqualified hybrid amount. FZ's inclusion in income (regardless of whether Country Z has a low or high tax rate) does not affect the result, because the hybrid transaction rule of §1.267A–2(a) applies if any no-inclusion occurs with respect to a specified recipient of the payment as a result of the payment being made pursuant to the hybrid transaction.

(iv) *Alternative facts—preferential rate.* The facts are the same as in paragraph (c)(1)(i) of this section, except that for Country X tax purposes US1's payment is treated as a dividend subject to a 4% tax rate, whereas the marginal rate imposed on ordinary income is 20%. FX includes $10x of the payment in income, calculated as $50x multiplied by 0.2 (.04, the rate at which the particular type of payment (a dividend for Country X tax purposes) is subject to tax in Country X, divided by 0.2, the marginal tax rate imposed on ordinary income). *See* §1.267A–3(a)(1). Thus, a $40x no-inclusion occurs with respect to FX ($50x less $10x). The $40x no-inclusion is a result of the payment being made pursuant to the hybrid transaction because, were the payment to be treated as interest for Country X tax purposes, FX would include the entire $50x in income at the full marginal rate imposed on ordinary income (20%) and, consequently, the no-inclusion would not occur. Accordingly, $40x of US1's payment is a disqualified hybrid amount.

(v) *Alternative facts—no-inclusion not the result of hybridity.* The facts are the same as in paragraph (c)(1)(i) of this section, except that Country X has a pure territorial regime (that is, Country X only taxes income with a domestic source). Although US1's payment is pursuant to a hybrid transaction and a $50x no-inclusion occurs with respect to FX, FX's no-inclusion is not a result of the payment being made pursuant to the hybrid transaction. This is because if Country X tax law were to treat the payment as interest, FX would include $0 in income and, consequently, the $50x no-inclusion would still occur. Accordingly, US1's payment is not a disqualified hybrid amount. *See* §1.267A–2(a)(1)(ii). The result would be the same if Country X instead did not impose a corporate income tax.

(vi) *Alternative facts—indebtedness under both tax laws but different ordering rules give rise to hybrid transaction; reduction of no-inclusion by reason of inclusion of a principal payment.* The facts are the same as in paragraph (c)(1)(i) of this section, except that the FX–US1 instrument is indebtedness for both U.S. and Country X tax purposes. In addition, the $50x date 1 payment is treated as interest for U.S. tax purposes and a repayment of principal for Country X tax purposes. On date 1, based on all the facts and circumstances (including the terms of the FX–US1 instrument, the tax laws of the United States and Country X, and an absence of a plan pursuant to which FX would dispose of the FX–US1 instrument), it is reasonably expected that on date 2 (a date that is within 36 months after the end of the taxable year of US1 that includes date 1), US1 will pay a total of $200x to FX and that, for U.S. tax purposes, $25x will be treated as interest and $175x as a repayment of principal, and, for Country X tax purposes, $75x will be treated as interest (and included in FX's income) and $125x as a repayment of principal. US1's $50x specified payment is made pursuant to a hybrid transaction and, but for §1.267A–3(a)(4), a $50x no-inclusion would occur with respect to FX. *See* §§1.267A–2(a)(2) and 1.267A–3(a)(1). However, pursuant to §1.267A–3(a)(4), FX's inclusion in income with respect to $50x of the date 2 amount that is a repayment of principal for U.S. tax purposes is treated as correspondingly reducing FX's no-inclusion with respect to the specified payment. As a result, as to US1's $50x specified payment, a no-inclusion does not occur with respect to FX. *See* §1.267A–3(a)(4). Therefore, US1's $50x specified payment is not a disqualified hybrid amount. *See* §1.267A–2(a)(1)(i).

(2) *Example 2. Payment pursuant to a repo transaction*—(i) *Facts.* FX holds all the interests of US1, and US1 holds all the interests of US2. On date 1, US1 and FX enter into a sale and repurchase transaction. Pursuant to the transaction, US1 transfers shares of preferred stock of US2 to FX in exchange for $1,000x, subject to a binding commitment of US1 to reacquire those shares on date 3 for an agreed price, which represents a repayment of the $1,000x plus a financing or time value of money return reduced by the amount of any distributions paid with respect to the preferred stock between dates 1 and 3 that are retained by FX. On date 2, US2 pays a $100x dividend on its preferred stock to FX. For Country X tax purposes, FX is treated as owning the US2 preferred stock and therefore is the beneficial owner of the dividend.

For U.S. tax purposes, the transaction is treated as a loan from FX to US1 that is secured by the US2 preferred stock. Thus, for U.S. tax purposes, US1 is treated as owning the US2 preferred stock and is the beneficial owner of the dividend. In addition, for U.S. tax purposes, US1 is treated as paying $100x of interest to FX (an amount corresponding to the $100x dividend paid by US2 to FX). Further, the marginal tax rate imposed on ordinary income under Country X tax law is 25%. Moreover, instead of a participation exemption, Country X tax law provides its tax residents a credit for underlying foreign taxes paid by a non-resident corporation from which a dividend is received; with respect to the $100x dividend received by FX from US2, the credit is $10x.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(2)(ii)(A) through (D) of this section, $40x of the payment is a disqualified hybrid amount under the hybrid transaction rule of §1.267A–2(a) and, as a result, $40x of the deduction is disallowed under §1.267A–1(b)(1).

(A) Although US1's $100x interest payment is not regarded under Country X tax law, a connected amount (US2's dividend payment) is regarded and derived by FX under such tax law. Thus, FX is considered a specified recipient with respect to US1's interest payment. *See* §1.267A–2(a)(3).

(B) US1's payment is made pursuant to a hybrid transaction because a payment with respect to the sale and repurchase transaction is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1), which does not regard the payment. *See* §1.267A–2(a)(2) and (f). Therefore, §1.267A–2(a) applies to the payment.

(C) For US1's payment to be a disqualified hybrid amount under §1.267A–2(a), a no-inclusion must occur with respect to FX. *See* §1.267A–2(a)(1)(i). As a consequence of Country X tax law not regarding US1's payment, FX includes $0 of the payment in income and therefore a $100x no-inclusion occurs with respect to FX. *See* §1.267A–3(a). However, FX includes $60x of a connected amount (US2's dividend payment) in income, calculated as $100x (the amount of the dividend) less $40x (the portion of the connected amount that is not included in income in Country X due to the foreign tax credit, determined by dividing the amount of the credit, $10x, by 0.25, the tax rate in Country X). *See* §1.267A–3(a). Pursuant to §1.267A–2(a)(3), FX's inclusion in income with respect to the connected amount correspondingly reduces the amount of its no-inclusion with respect to US1's payment. Therefore, for purposes of §1.267A–2(a), FX's no-inclusion with respect to US1's payment is $40x ($100x less $60x). *See* §1.267A–2(a)(3).

(D) Pursuant to §1.267A–2(a)(1)(ii), FX's $40x no-inclusion gives rise to a disqualified hybrid amount to the extent that FX's no-inclusion is a result of US1's payment being made pursuant to the hybrid transaction. FX's $40x no-inclusion is a result of US1's payment being made pursuant to the hybrid transaction because, were the sale and repurchase transaction to be treated as a loan from FX to US1 for Country X tax purposes, FX would include US1's $100x interest payment in income (because it would not be entitled to a foreign tax credit) and, consequently, the no-inclusion would not occur.

(iii) *Alternative facts—structured arrangement.* The facts are the same as in paragraph (c)(2)(i) of this section, except that FX is a bank that is unrelated to US1. In addition, the sale and repurchase transaction is a structured arrangement and FX is a party to the structured arrangement. The result is the same as in paragraph (c)(2)(ii) of this section. That is, even though FX is not related to US1, it is taken into account with respect to the determinations under §1.267A–2(a) because it is a party to a structured arrangement pursuant to which the payment is made. *See* §1.267A–2(f).

(3) *Example 3. Disregarded payment*—(i) *Facts.* FX holds all the interests of US1. For Country X tax purposes, US1 is a disregarded entity of FX. During taxable year 1, US1 pays $100x to FX pursuant to a debt instrument. The amount is treated as interest for U.S. tax purposes but is disregarded for

Country X tax purposes as a transaction involving a single taxpayer. During taxable year 1, US1's only other items of income, gain, deduction, or loss are $125x of gross income (the entire amount of which is included in US1's income) and a $60x item of deductible expense. The $125x item of gross income is included in FX's income, and the $60x item of deductible expense is allowable for Country X tax purposes.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(3)(ii)(A) and (B) of this section, $35x of the payment is a disqualified hybrid amount under the disregarded payment rule of §1.267A–2(b) and, as a result, $35x of the deduction is disallowed under §1.267A–1(b)(1).

(A) US1's $100x payment is not regarded under the tax law of Country X (the tax law of FX, a related tax resident to which the payment is made) because under such tax law the payment involves a single taxpayer. *See* §1.267A–2(b)(2) and (f). In addition, were the tax law of Country X to regard the payment (and treat it as interest), FX would include it in income. Therefore, the payment is a disregarded payment to which §1.267A–2(b) applies. *See* §1.267A–2(b)(2).

(B) Under §1.267A–2(b)(1), the excess (if any) of US1's disregarded payments for taxable year 1 ($100x) over its dual inclusion income for the taxable year is a disqualified hybrid amount. US1's dual inclusion income for taxable year 1 is $65x, calculated as $125x (the amount of US1's gross income that is included in FX's income) less $60x (the amount of US1's deductible expenses, other than deductions for disregarded payments, that are allowable for Country X tax purposes). *See* §1.267A–2(b)(3). Therefore, $35x is a disqualified hybrid amount ($100x less $65x). *See* §1.267A–2(b)(1).

(iii) *Alternative facts—non-dual inclusion income arising from hybrid transaction.* The facts are the same as in paragraph (c)(3)(i) of this section, except that US1 holds all the interests of FZ (a specified party that is a CFC) and US1's only item of income, gain, deduction, or loss during taxable year 1 (other than the $100x payment to FX) is $80x paid to US1 by FZ pursuant to an instrument treated as indebtedness for U.S. and Country Z tax purposes and equity for Country X tax purposes (the US1–FZ instrument). The $80x is treated as interest for Country Z and U.S. tax purposes (the entire amount of which is included in US1's income) and is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption). Paragraphs (c)(3)(iii)(A) and (B) of this section describe the extent to which the specified payments by FZ and US1, each of which is a specified party, are disqualified hybrid amounts.

(A) The hybrid transaction rule of §1.267A–2(a) applies to FZ's payment because the payment is made pursuant to a hybrid transaction, as a payment with respect to the US1–FZ instrument is treated as interest for U.S. tax purposes but not for purposes of Country X's tax law (the tax law of FX, a specified recipient that is related to FZ). As a consequence of the Country X participation exemption, an $80x no-inclusion occurs with respect to FX, and such no-inclusion is a result of the payment being made pursuant to the hybrid transaction. Thus, but for §1.267A–3(b), the entire $80x of FZ's payment would be a disqualified hybrid amount. However, because US1 (a tax resident of the United States that is also a specified recipient of the payment) takes the entire $80x payment into account in its gross income, no portion of the payment is a disqualified hybrid amount. *See* §1.267A–3(b)(2).

(B) The disregarded payment rule of §1.267A–2(b) applies to US1's $100x payment to FX, for the reasons described in paragraph (c)(3)(ii)(A) of this section. In addition, US1 has no dual inclusion income for taxable year 1 because, as a result of the Country X participation exemption, no portion of FZ's $80x payment to US1 (which is derived by FX under its tax law) is included in FX's income. *See* §§1.267A–2(b)(3) and 1.267A–3(a). Therefore, the entire $100x payment from US1 to FX is a disqualified hybrid amount, calculated as $100x (the amount of the payment) less $0 (the amount of dual inclusion income). *See* §1.267A–2(b)(1).

(iv) *Alternative facts—dual inclusion income despite participation exemption.* The facts are the same as in paragraph (c)(3)(iii) of this section, except that the US1–FZ instrument is treated as indebtedness for U.S. tax purposes and equity for Country Z and Country X tax purposes. In addition, the $80x paid to US1 by FZ is treated as interest for U.S. tax purposes (the entire amount of which is included in US1's income), a dividend for Country Z tax purposes (for which FZ is not allowed a deduction or other tax benefit), and an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption). For the reasons described in paragraph (c)(3)(iii)(A) of this section, the hybrid transaction rule of § 1.267A–2(a) applies to FZ's payment but no portion of the payment is a disqualified hybrid amount. In addition, the disregarded payment rule of § 1.267A–2(b) applies to US1's $100x payment to FX, for the reasons described in paragraph (c)(3)(ii)(B) of this section. US1's dual inclusion income for taxable year 1 is $80x. This is because the $80x paid to US1 by FZ is included in US1's income and, although not included in FX's income, it is a dividend for Country X tax purposes that would have been included in FX's income but for the Country X participation exemption, and FZ is not allowed a deduction or other tax benefit for it under Country Z tax law. *See* § 1.267A–2(b)(3)(ii). Therefore, $20x of US1's $100x payment is a disqualified hybrid amount ($100x less $80x). *See* § 1.267A–2(b)(1).

(4) *Example 4. Payment allocable to a U.S. taxable branch*—(i) *Facts.* FX1 and FX2 are foreign corporations that are bodies corporate established in and tax residents of Country X. FX1 holds all the interests of FX2, and FX1 and FX2 file a consolidated return under Country X tax law. FX2 has a U.S. taxable branch (''USB''). During taxable year 1, FX2 pays $50x to FX1 pursuant to an instrument (the ''FX1–FX2 instrument''). The amount paid pursuant to the instrument is treated as interest for U.S. tax purposes but, as a consequence of the Country X consolidation regime, is treated as a disregarded transaction between group members for Country X tax purposes. Also during taxable year 1, FX2 pays $100x of interest to an unrelated bank that is not a party to a structured arrangement (the instrument pursuant to which the payment is made, the ''bank-FX2 instrument''). FX2's only other item of income, gain, deduction, or loss for taxable year 1 is $200x of gross income. Under Country X tax law, the $200x of gross income is attributable to USB, but is not included in FX2's income because Country X tax law exempts income attributable to a branch. Under U.S. tax law, the $200x of gross income is effectively connected income of USB. Further, under section 882(c)(1), $75x of interest is, for taxable year 1, allocable to USB's effectively connected income. USB has neither liabilities that are directly allocable to it, as described in § 1.882–5(a)(1)(ii)(A), nor U.S. booked liabilities, as defined in § 1.882–5(d)(2).

(ii) *Analysis.* USB is a specified party and thus any interest or royalty allowable as a deduction in determining its effectively connected income is subject to disallowance under section 267A. Pursuant to § 1.267A–5(b)(3)(i)(A), USB is treated as paying $75x of interest, and such interest is thus a specified payment. Of that $75x, $25x is treated as paid to FX1, calculated as $75x (the interest allocable to USB under section 882(c)(1)) multiplied by ⅓ ($50x, FX2's payment to FX1, divided by $150x, the total interest paid by FX2). *See* § 1.267A–5(b)(3)(ii)(A). As described in paragraphs (c)(4)(ii)(A) and (B) of this section, the $25x of the specified payment treated as paid by USB to FX1 is a disqualified hybrid amount under the disregarded payment rule of § 1.267A–2(b) and, as a result, a deduction for that amount is disallowed under § 1.267A–1(b)(1).

(A) USB's $25x payment to FX1 is not regarded under the tax law of Country X (the tax law of FX1, a related tax resident to which the payment is made) because under such tax law it is a disregarded transaction between group members. *See* § 1.267A–2(b)(2) and (f). In addition, were the tax law of Country X to regard the payment (and treat it as interest), FX1 would include it in income. Therefore, the payment is a disregarded payment to which § 1.267A–2(b) applies. *See* § 1.267A–2(b)(2).

(B) Under § 1.267A–2(b)(1), the excess (if any) of USB's disregarded payments for taxable year 1 ($25x) over its dual inclusion income for the taxable year is a disqualified hybrid amount. USB's dual inclusion income for taxable year 1 is $0. This is because, as a result of the Country X exemption for income attributable to a branch, no portion of USB's $200x item of gross income is included in FX2's income. *See* § 1.267A–2(b)(3). Therefore, the entire $25x of the specified payment treated as paid by USB to FX1 is a disqualified hybrid amount, calculated as $25x (the amount of the payment) less $0 (the amount of dual inclusion income). *See* § 1.267A–2(b)(1).

(iii) *Alternative facts—deemed branch payment.* The facts are the same as in paragraph (c)(4)(i) of this section, except that FX2 does not pay any amounts during taxable year 1 (thus, it does not pay the $50x to FX1 or the $100x to the bank). However, under an income tax treaty between the United States and Country X, USB is a U.S. permanent establishment and, for taxable year 1, $25x of royalties is allowable as a deduction in computing the business profits of USB and is deemed paid to FX2. Under Country X tax law, the $25x is not regarded. Accordingly, the $25x is a specified payment that is a deemed branch payment. *See* §§ 1.267A–2(c)(2) and 1.267A–5(b)(3)(i)(B). In addition, the entire $25x is a disqualified hybrid amount for which a deduction is disallowed because the tax law of Country X provides an exclusion or exemption for income attributable to a branch. *See* § 1.267A–2(c)(1).

(5) *Example 5. Payment to a reverse hybrid*—(i) *Facts.* FX holds all the interests of US1 and FY, and FY holds all the interests of FV. FY is an entity established in Country Y, and FV is an entity established in Country V. FY is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes. FV is fiscally transparent for Country X tax purposes. On date 1, US1 pays $100x to FY. The payment is treated as interest for U.S. tax purposes and Country X tax purposes.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(5)(ii)(A) through (C) of this section, the entire $100x payment is a disqualified hybrid amount under the reverse hybrid rule of § 1.267A–2(d) and, as a result, a deduction for the payment is disallowed under § 1.267A–1(b)(1).

(A) US1's payment is made to a reverse hybrid because FY is fiscally transparent under the tax law of Country Y (the tax law of the country in which it is established) but is not fiscally transparent under the tax law of Country X (the tax law of FX, an investor that is related to US1). *See* § 1.267A–2(d)(2) and (f). Therefore, § 1.267A–2(d) applies to the payment. The result would be the same if the payment were instead made to FV. *See* § 1.267A–2(d)(3).

(B) For US1's payment to be a disqualified hybrid amount under § 1.267A–2(d), a no-inclusion must occur with respect to FX, an investor the tax law of which treats FY as not fiscally transparent. *See* § 1.267A–2(d)(1)(i). Because FX does not derive the $100x payment under Country X tax law (as FY is not fiscally transparent under such tax law), FX includes $0 of the payment in income and therefore a $100x no-inclusion occurs with respect to FX. *See* § 1.267A–3(a).

(C) Pursuant to § 1.267A–2(d)(1)(ii), FX's $100x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being made to the reverse hybrid. FX's $100x no-inclusion is a result of the payment being made to the reverse hybrid because, were FY to be treated as fiscally transparent for Country X tax purposes, FX would include $100x in income and, consequently, the no-inclusion would not occur. The result would be the same if Country X tax law instead viewed US1's payment as a dividend, rather than interest. *See* § 1.267A–2(d)(1)(ii).

(iii) *Alternative facts—inclusion under anti-deferral regime.* The facts are the same as in paragraph (c)(5)(i) of this section, except that, under a Country X anti-deferral regime, FX takes into account $100x attributable to the $100x payment received by FY. If under the rules of § 1.267A–3(a) FX includes the entire attributed amount in income (that is, if FX takes the amount into account in its income at the full marginal rate imposed on ordinary income and the amount is not reduced or offset by certain relief particular to the amount), then a no-inclusion does not occur with respect to FX. As a result, in such a case, no portion of US1's payment would be a disqualified hybrid amount under § 1.267A–2(d).

(iv) *Alternative facts—multiple investors.* The facts are the same as in paragraph (c)(5)(i) of this section, except that FX holds all the interests of FZ, which is fiscally transparent for Country X tax purposes; FZ holds all the interests of FY, which is fiscally transparent for Country Z tax purposes; and FZ includes the $100x payment in income. Thus, each of FZ and FX is an investor of FY, as each directly or indirectly holds an interest of FY. *See* § 1.267A–5(a)(13). A $100x no-inclusion occurs with respect to FX, an investor the tax law of which treats FY as not fiscally transparent. FX's no-inclusion is a result of the payment being made to the reverse hybrid because, were FY to be treated as fiscally transparent for Country X tax purposes, then FX would include $100x in income (as FZ is fiscally transparent for Country X tax purposes). Accordingly, FX's no-inclusion is a result of US1's payment being made to the reverse hybrid and, consequently, the entire $100x payment is a disqualified hybrid amount. However, if instead FZ were not fiscally transparent for Country X tax purposes, then FX's no-inclusion would not be a result of US1's payment being made to the reverse hybrid and, therefore, the payment would not be a disqualified hybrid amount under § 1.267A–2(d).

(v) *Alternative facts—portion of no-inclusion not the result of hybridity.* The facts are the same as in paragraph (c)(5)(i) of this section, except that the $100x is viewed as a royalty for U.S. tax purposes and Country X tax purposes, and Country X tax law contains a patent box regime that provides an 80% deduction with respect to certain royalty income. If the royalty payment would qualify for the Country X patent box deduction were FY to be treated as fiscally transparent for Country X tax purposes, then only $20x of FX's $100x no-inclusion would be the result of the payment being paid to a reverse hybrid, calculated as $100x (the no-inclusion with respect to FX that actually occurs) less $80x (the no-inclusion with respect to FX that would occur if FY were to be treated as fiscally transparent for Country X tax purposes). *See* § 1.267A–2(d)(1)(ii) and 1.267A–3(a)(1)(ii). Accordingly, in such a case, only $20x of US1's payment would be a disqualified hybrid amount under § 1.267A–2(d).

(vi) *Alternative facts—payment to a discretionary trust*—(A) *Facts.* The facts are the same as in paragraph (c)(5)(i) of this section, except that FY is a discretionary trust established in, and a tax resident of, Country Y (and as a result, FY is generally not fiscally transparent for Country Y tax purposes under the principles of § 1.894–1(d)(3)(ii)). In general, under Country Y tax law, FX, an investor of FY, is not required to separately take into account in its income US1's $100x payment received by FY; instead, FY is required to take the payment into account in its income. However, under the trust agreement, the trustee of FY may, with respect to certain items of income received by FY, allocate such an item to FY's beneficiary, FX. When this occurs, then, for Country Y tax purposes, FY does not take the item into account in its income, and FX is required to take the item into account in its income as if it received the item directly from the source from which realized by FY. For Country X tax purposes, FX in all cases does not take into account in its income any item of income received by FY. With respect to the $100x paid from US1 to FY, the trustee allocates the $100x to FX.

(B) *Analysis.* FY is fiscally transparent with respect to US1's $100x payment under the tax law of Country Y (the tax law of the country in which FY is established). *See* § 1.267A–5(a)(8)(i). In addition, FY is not fiscally transparent with respect to US1's $100x payment under the tax law of Country X (the tax law of FX, the investor of FY). *See* § 1.267A–5(a)(8)(ii). Thus, FY is a reverse hybrid with respect to the payment. *See* § 1.267A–2(d)(2) and (f). Therefore, for reasons similar to those discussed in paragraphs (c)(5)(ii)(B) and (C) of this section, the entire $100x payment is a disqualified hybrid amount.

(6) *Example 6. Branch mismatch payment*—(i) *Facts.* FX holds all the interests of US1 and FZ. FZ owns BB, a Country B branch that gives rise to a taxable presence in Country B under Country Z tax law but not under Country B tax law. On date 1, US1 pays $50x to FZ. The amount is treated as a royalty for U.S. tax purposes and Country Z tax purposes. Under Country Z tax law, the amount is treated as income attributable to BB and, as a consequence of County Z tax law exempting income attributable to a branch, is excluded from FZ's income.

(ii) *Analysis.* US1 is a specified party and thus a deduction for its $50x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(6)(ii)(A) through (C) of this section, the entire $50x payment is a disqualified hybrid amount under the branch mismatch rule of §1.267A–2(e) and, as a result, a deduction for the payment is disallowed under §1.267A–1(b)(1).

(A) US1's payment is a branch mismatch payment because under Country Z tax law (the tax law of FZ, a home office that is related to US1) the payment is treated as income attributable to BB, and BB is not a taxable branch (that is, under Country B tax law, BB does not give rise to a taxable presence). *See* §1.267A–2(e)(2) and (f). Therefore, §1.267A–2(e) applies to the payment. The result would be the same if instead BB were a taxable branch and, under Country B tax law, US1's payment were treated as income attributable to FZ, the home office, and not BB. *See* §1.267A–2(e)(2).

(B) For US1's payment to be a disqualified hybrid amount under §1.267A–2(e), a no-inclusion must occur with respect to FZ. *See* §1.267A–2(e)(1)(i). As a consequence of the Country Z branch exemption, FZ includes $0 of the payment in income and therefore a $50x no-inclusion occurs with respect to FZ. *See* §1.267A–3(a).

(C) Pursuant to §1.267A–2(e)(1)(ii), FZ's $50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1's payment being a branch mismatch payment. FZ's $50x no-inclusion is a result of the payment being a branch mismatch payment because, were the payment to not be treated as income attributable to BB for Country Z tax purposes, FZ would include $50x in income and, consequently, the no-inclusion would not occur.

(7) *Example 7. Reduction of disqualified hybrid amount for certain amounts includible in income*—(i) *Facts.* US1 and FW hold 60% and 40%, respectively, of the interests of FX, and FX holds all the interests of FZ. Each of FX and FZ is a specified party that is a CFC. FX holds an instrument issued by FZ that it is treated as equity for Country X tax purposes and as indebtedness for U.S. tax purposes (the FX–FZ instrument). On date 1, FZ pays $100x to FX pursuant to the FX–FZ instrument. The amount is treated as a dividend for Country X tax purposes and as interest for U.S. tax purposes. In addition, pursuant to section 954(c)(6), the amount is not foreign personal holding company income of FX and, under section 951A, the amount is gross tested income (as described in §1.951A–2(c)(1)) of FX. Further, were FZ allowed a deduction for the amount, it would be allocated and apportioned to gross tested income (as described in §1.951A–2(c)(1)) of FZ. Lastly, Country X tax law provides an 80% participation exemption for dividends received from nonresident corporations and, as a result of such participation exemption, FX includes $20x of FZ's payment in income.

(ii) *Analysis.* FZ, a CFC, is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. But for §1.267A–3(b), $80x of FZ's payment would be a disqualified hybrid amount (such amount, a ‘‘tentative disqualified hybrid amount''). *See* §§1.267A–2(a) and 1.267A–3(b)(1). Pursuant to §1.267A–3(b), the tentative disqualified hybrid amount is reduced by $48x. *See* §1.267A–3(b)(4). The $48x is the tentative disqualified hybrid amount to the extent that it increases US1's pro rata share of tested income with respect to FX under section 951A (calculated as $80x multiplied by 60%). *See* §1.267A–3(b)(4). Accordingly, $32x of FZ's payment ($80x less $48x) is a disqualified hybrid amount under §1.267A–2(a) and, as a result, $32x of the deduction is disallowed under §1.267A–1(b)(1).

(iii) *Alternative facts—United States shareholder is a domestic partnership*. The facts are the same as in paragraph (c)(7)(i) of this section, except that US1 is a domestic partnership, 90% of the interests of which are held by US2 and the remaining 10% of which are held by an individual that is a nonresident alien (as defined in section 7701(b)(1)(B)). Thus, although each of US1 and US2 is a United States shareholder of FX, only US2 has a pro rata share of any tested item of FX. *See* §1.951A–1(e). In addition, \$43.2x of the \$80x tentative disqualified hybrid amount increases US2's pro rata share of the tested income of FX (calculated as \$80x multiplied by 60% multiplied by 90%). Thus, \$36.8x of FZ's payment (\$80x less \$43.2x) is a disqualified hybrid amount under §1.267A–2(a). *See* §1.267A–3(b)(4).

(8) *Example 8. Imported mismatch rule—direct offset*—(i) *Facts*. FX holds all the interests of FW, and FW holds all the interests of US1. FX holds an instrument issued by FW that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX–FW instrument). FW holds an instrument issued by US1 that is treated as indebtedness for Country W and U.S. tax purposes (the FW–US1 instrument). In accounting period 1, FW pays \$100x to FX pursuant to the FX–FW instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays \$100x to FW pursuant to the FW–US1 instrument. The amount is treated as interest for Country W and U.S. tax purposes and is included in FW's income. The FX–FW instrument was not entered into pursuant to the same plan or series of related transactions pursuant to which the FW–US1 instrument was entered into.

(ii) *Analysis*. US1 is a specified party and thus a deduction for its \$100x specified payment is subject to disallowance under section 267A. US1's \$100x payment is neither a disqualified hybrid amount nor included or includible in income in the United States. *See* §1.267A–4(a)(2)(v). In addition, FW's \$100x deduction is a hybrid deduction because it is a deduction allowed to FW that results from an amount paid that is interest under Country W tax law, and were Country W law to have rules substantially similar to those under §§1.267A–1 through 1.267A–3 and 1.267A–5, a deduction for the payment would be disallowed (because under such rules the payment would be pursuant to a hybrid transaction and FX's no-inclusion would be a result of the hybrid transaction). *See* §§1.267A–2(a) and 1.267A–4(b). Under §1.267A–4(a)(2), US1's payment is an imported mismatch payment, US1 is an imported mismatch payer, and FW (the foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. The imported mismatch payment is a disqualified imported mismatch amount to the extent that the income attributable to the payment is directly or indirectly offset by the hybrid deduction incurred by FW (a foreign tax resident that is related to US1). *See* §1.267A–4(a)(1). Under §1.267A–4(c)(1), the \$100x hybrid deduction directly or indirectly offsets the income attributable to US1's imported mismatch payment to the extent that the payment directly or indirectly funds the hybrid deduction. The entire \$100x of US1's payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. *See* §1.267A–4(c)(3)(i). Accordingly, the entire \$100x payment is a disqualified imported mismatch amount under §1.267A–4(a)(1) and, as a result, a deduction for the payment is disallowed under §1.267A–1(b)(2).

(iii) *Alternative facts—long-term deferral*. The facts are the same as in paragraph (c)(8)(i) of this section, except that the FX–FW instrument is treated as indebtedness for Country X and Country W tax purposes, and FW does not pay any amounts pursuant to the instrument during accounting period 1. In addition, under Country W tax law, FW is allowed to deduct interest under the FX–FW instrument as it accrues, whereas under Country X tax law FX does not take into account in its income interest under the FX–FW instrument until the interest is paid. Further, FW accrues \$100x of interest during accounting period 1, and FW will not pay such amount to FX for more than 36 months after the end of accounting period 1. The results are the same as in paragraph (c)(8)(ii) of this section. That is, FW's $100x deduction for the accrued interest is a hybrid deduction, *see* §§1.267A–2(a), 1.267A–3(a), and 1.267A–4(b), and the income attributable to US1's $100x imported mismatch payment is offset by the hybrid deduction for the reasons described in paragraph (c)(8)(ii) of this section. As a result, a deduction for the payment is disallowed under §1.267A–1(b)(2). The result would be the same even if the FX–FW instrument is expected to be redeemed or capitalized before the $100x of interest is paid such that FX will never take into account in its income (and therefore will not include in income) the $100x of interest.

(iv) *Alternative facts—notional interest deduction.* The facts are the same as in paragraph (c)(8)(i) of this section, except that there is no FX–FW instrument and thus FW does not pay any amounts to FX during accounting period 1. However, during accounting period 1, FW is allowed a $100x notional interest deduction with respect to its equity under Country W tax law. Pursuant to §1.267A–4(b)(1)(ii), FW's notional interest deduction is a hybrid deduction. The results are the same as in paragraph (c)(8)(ii) of this section. That is, the income attributable to US1's $100x imported mismatch payment is offset by FW's hybrid deduction for the reasons described in paragraph (c)(8)(ii) of this section. As a result, a deduction for the payment is disallowed under §1.267A–1(b)(2). The result would be the same if the tax law of Country W contains hybrid mismatch rules because FW's deduction is a deduction with respect to equity. *See* §1.267A–4(b)(2)(i).

(v) *Alternative facts—foreign hybrid mismatch rules prevent hybrid deduction.* The facts are the same as in paragraph (c)(8)(i) of this section, except that the tax law of Country W contains hybrid mismatch rules, and under such rules FW is not allowed a deduction for the $100x that it pays to FX pursuant to the FX–FW instrument. The $100x paid by FW therefore does not give rise to a hybrid deduction. *See* §1.267A–4(b). Accordingly, because the income attributable to US1's payment to FW is not directly or indirectly offset by a hybrid deduction, the payment is not a disqualified imported mismatch amount. Therefore, a deduction for the payment is not disallowed under §1.267A–1(b)(2).

(9) *Example 9. Imported mismatch rule—indirect offsets and pro rata allocations*—(i) *Facts.* FX holds all the interests of FZ, and FZ holds all the interests of US1 and US2. FX has a Country B branch that, for Country X and Country B tax purposes, gives rise to a taxable presence in Country B and is therefore a taxable branch (''BB''). Under the Country B-Country X income tax treaty, BB is a permanent establishment entitled to deduct expenses properly attributable to BB for purposes of computing its business profits under the treaty. In addition, BB is deemed to pay a royalty to FX for the right to use intangibles developed by FX equal to cost plus y%. The deemed royalty is a deductible expense properly attributable to BB under the Country B-Country X income tax treaty. For Country X tax purposes, any transactions between BB and X are disregarded. The deemed royalty is $80x for accounting period 1. Country B tax law does not permit a loss of a taxable branch to be shared with a tax resident or another taxable branch. In addition, an instrument issued by FZ to FX is properly reflected as an asset on the books and records of BB (the FX–FZ instrument). The FX–FZ instrument is treated as indebtedness for Country X, Country Z, and Country B tax purposes. In accounting period 1, FZ pays $80x to FX pursuant to the FX–FZ instrument; the amount is treated as interest for Country X, Country Z, and Country B tax purposes, and is treated as income attributable to BB for Country X and Country B tax purposes (but, for Country X tax purposes, is excluded from FX's income as a consequence of the Country X exemption for income attributable to a branch). Further, in accounting period 1, US1 and US2 pay $60x and $40x, respectively, to FZ pursuant to instruments that are treated as indebtedness for Country Z and U.S. tax purposes; the amounts are treated as interest for Country Z and U.S. tax purposes and are included in FZ's income. Lastly, neither the instrument

pursuant to which US1 pays the $60x nor the instrument pursuant to which US2 pays the $40x was entered into pursuant to a plan or series of related transactions that includes the transaction or agreement giving rise to BB's deduction for the deemed royalty.

(ii) *Analysis*. US1 and US2 are specified parties and thus deductions for their specified payments are subject to disallowance under section 267A. Neither of the payments is a disqualified hybrid amount, nor is either of the payments included or includible in income in the United States. *See* §1.267A–4(a)(2)(v). In addition, BB's $80x deduction for the deemed royalty is a hybrid deduction because it is a deduction allowed to BB that results from an amount paid that is treated as a royalty under Country B tax law (regardless of whether a royalty deduction would be allowed under U.S. law), and were Country B tax law to have rules substantially similar to those under §§1.267A–1 through 1.267A–3 and 1.267A–5, a deduction for the payment would be disallowed because under such rules the payment would be a deemed branch payment and Country X has an exclusion for income attributable to a branch. *See* §§1.267A–2(c) and 1.267A–4(b). Under §1.267A–4(a)(2), each of US1's and US2's payments is an imported mismatch payment, US1 and US2 are imported mismatch payers, and FZ (the foreign tax resident that includes the imported mismatch payments in income) is an imported mismatch payee. The imported mismatch payments are disqualified imported mismatch amounts to the extent that the income attributable to the payments is directly or indirectly offset by the hybrid deduction incurred by BB (a foreign taxable branch that is related to US1 and US2). *See* §1.267A–4(a). Under §1.267A–4(c)(1), the $80x hybrid deduction directly or indirectly offsets the income attributable to the imported mismatch payments to the extent that the payments directly or indirectly fund the hybrid deduction. Paragraphs (c)(9)(ii)(A) and (B) of this section describe the extent to which the imported mismatch payments directly or indirectly fund the hybrid deduction.

(A) Neither US1's nor US2's payment directly funds the hybrid deduction because FZ (the imported mismatch payee) does not incur the hybrid deduction. *See* §1.267A–4(c)(3)(i). To determine the extent to which the payments indirectly fund the hybrid deduction, the amount of the hybrid deduction that is allocated to FZ must be determined. *See* §1.267A–4(c)(3)(ii). FZ is allocated the hybrid deduction to the extent that it directly or indirectly makes a funded taxable payment to BB (the foreign taxable branch that incurs the hybrid deduction). *See* §1.267A–4(c)(3)(iii). The $80x that FZ pays pursuant to the FX–FZ instrument is a funded taxable payment of FZ to BB. *See* §1.267A–4(c)(3)(v). Therefore, because FZ makes a funded taxable payment to BB that is at least equal to the amount of the hybrid deduction, FZ is allocated the entire amount of the hybrid deduction. *See* §1.267A–4(c)(3)(iii).

(B) But for US2's imported mismatch payment, the entire $60x of US1's imported mismatch payment would indirectly fund the hybrid deduction because FZ is allocated at least that amount of the hybrid deduction. *See* §1.267A–4(c)(3)(ii). Similarly, but for US1's imported mismatch payment, the entire $40x of US2's imported mismatch payment would indirectly fund the hybrid deduction because FZ is allocated at least that amount of the hybrid deduction. *See* §1.267A–4(c)(3)(ii). However, because the sum of US1's and US2's imported mismatch payments to FZ ($100x) exceeds the hybrid deduction allocated to FZ ($80x), pro rata adjustments must be made. *See* §1.267A–4(e). Thus, $48x of US1's imported mismatch payment is considered to indirectly fund the hybrid deduction, calculated as $80x (the amount of the hybrid deduction) multiplied by 60% ($60x, the amount of US1's imported mismatch payment to FZ, divided by $100x, the sum of the imported mismatch payments that US1 and US2 make to FZ). Similarly, $32x of US2's imported mismatch payment is considered to indirectly fund the hybrid deduction, calculated as $80x (the amount of the hybrid deduction) multiplied by 40% ($40x, the amount of US2's imported mismatch payment to FZ, divided by

$100x, the sum of the imported mismatch payments that US1 and US2 make to FZ). Accordingly, $48x of US1's imported mismatch payment, and $32x of US2's imported mismatch payment, are disqualified imported mismatch amounts under §1.267A–4(a)(1) and, as a result, deductions for such amounts are disallowed under §1.267A–1(b)(2).

(iii) *Alternative facts—loss made available through foreign group relief regime.* The facts are the same as in paragraph (c)(9)(i) of this section, except that FZ holds all the interests in FZ2, a body corporate that is a tax resident of Country Z, FZ2 (rather than FZ) holds all the interests of US1 and US2, and US1 and US2 make their respective $60x and $40x payments to FZ2 (rather than to FZ). Further, in accounting period 1, a $10x loss of FZ is made available to offset income of FZ2 through a Country Z foreign group relief regime. Pursuant to §1.267A–4(c)(3)(vi), FZ and FZ2 are treated as a single foreign tax resident for purposes of §1.267A–4(c) because a loss that is not incurred by FZ2 (FZ's $10x loss) is made available to offset income of FZ2 under the Country Z group relief regime. Accordingly, the results are the same as in paragraph (c)(9)(ii) of this section. That is, by treating FZ and FZ2 as a single foreign tax resident for purposes of §1.267A–4(c), BB's hybrid deduction offsets the income attributable to US1's and US2's imported mismatch payments to the same extent as described in paragraph (c)(9)(ii) of this section.

(10) *Example 10. Imported mismatch rule—ordering rules and rule deeming certain payments to be imported mismatch payments*—(i) *Facts.* FX holds all the interests of FW, and FW holds all the interests of US1, US2, and FZ. FZ holds all the interests of US3. FX transfers cash to FW in exchange for an instrument that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX–FW instrument). FW transfers cash to US1 in exchange for an instrument that is treated as indebtedness for Country W and U.S. tax purposes (the FW–US1 instrument). The FX–FW instrument and the FW–US1 instrument were entered into pursuant to a plan a design of which was for deductions incurred by FW pursuant to the FX–FW instrument to offset income attributable to payments by US1 pursuant to the FW–US1 instrument. In accounting period 1, FW pays $125x to FX pursuant to the FX–FW instrument; the amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption regime) and as interest for Country W tax purposes. Also in accounting period 1, US1 pays $50x to FW pursuant to the FW–US1 instrument; US2 pays $50x to FW pursuant to an instrument treated as indebtedness for Country W and U.S. tax purposes (the FW–US2 instrument); US3 pays $50x to FZ pursuant to an instrument treated as indebtedness for Country Z and U.S. tax purposes (the FZ–US3 instrument); and FZ pays $50x to FW pursuant to an instrument treated as indebtedness for Country W and Country Z tax purposes (FW–FZ instrument). The amounts paid by US1, US2, US3, and FZ are treated as interest for purposes of the relevant tax laws and are included in the income of FW (in the case of US1's, US2's and FZ's payment) or FZ (in the case of US3's payment). Lastly, neither the FW–US2 instrument, the FW–FZ instrument, nor the FZ–US3 instrument was entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FX–FW instrument was entered into.

(ii) *Analysis.* US1, US2, and US3 are specified parties (but FZ is not a specified party, see §1.267A–5(a)(17)) and thus deductions for US1's, US2's, and US3's specified payments are subject to disallowance under section 267A. None of the specified payments is a disqualified hybrid amount, nor is any of the payments included or includible in income in the United States. *See* §1.267A–4(a)(2)(v). Under §1.267A–4(a)(2), each of the payments is an imported mismatch payment, US1, US2, and US3 are imported mismatch payers, and FW and FZ (the foreign tax residents that include the imported mismatch payments in income) are imported mismatch payees. The imported mismatch payments are disqualified imported mismatch amounts to the extent that the income attributable to the payments is directly or indirectly offset by

FW's $125x hybrid deduction. *See* § 1.267A–4(a)(1) and (b). Under § 1.267A–4(c)(1), the $125x hybrid deduction directly or indirectly offsets the income attributable to the imported mismatch payments to the extent that the payments directly or indirectly fund the hybrid deduction. Paragraphs (c)(10)(ii)(A) through (C) of this section describe the extent to which the imported mismatch payments directly or indirectly fund the hybrid deduction and are therefore disqualified hybrid amounts for which a deduction is disallowed under § 1.267A–1(b)(2).

(A) First, the $125x hybrid deduction offsets the income attributable to US1's imported mismatch payment, a factually-related imported mismatch payment that directly funds the hybrid deduction. *See* § 1.267A–4(c)(2)(i). The entire $50x of US1's payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i). Accordingly, the entire $50x of the payment is a disqualified imported mismatch amount under § 1.267A–4(a)(1).

(B) Second, the remaining $75x hybrid deduction offsets the income attributable to US2's imported mismatch payment, a factually-unrelated imported mismatch payment that directly funds the remaining hybrid deduction. *See* § 1.267A–4(c)(2)(ii). The entire $50x of US2's payment directly funds the remaining hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the remaining hybrid deduction. *See* § 1.267A–4(c)(3)(i). Accordingly, the entire $50x of the payment is a disqualified imported mismatch amount under § 1.267A–4(a)(1).

(C) Third, the remaining $25x hybrid deduction offsets the income attributable to US3's imported mismatch payment, a factually-unrelated imported mismatch payment that indirectly funds the remaining hybrid deduction. *See* § 1.267A–4(c)(2)(iii). The imported mismatch payment indirectly funds the remaining hybrid deduction to the extent that FZ (the imported mismatch payee) is allocated the remaining hybrid deduction. *See* § 1.267A–4(c)(3)(ii). FZ is allocated the remaining hybrid deduction to the extent that it directly or indirectly makes a funded taxable payment to FW (the tax resident that incurs the hybrid deduction). *See* § 1.267A–4(c)(3)(iii). The $50x that FZ pays to FW pursuant to the FW–FZ instrument is a funded taxable payment of FZ to FW. *See* § 1.267A–4(c)(3)(v). Therefore, because FZ makes a funded taxable payment to FW that is at least equal to the amount of the remaining hybrid deduction, FZ is allocated the remaining hybrid deduction. *See* § 1.267A–4(c)(3)(iii). Accordingly, $25x of US3's payment indirectly funds the $25x remaining hybrid deduction and, consequently, $25x of US3's payment is a disqualified imported mismatch amount under § 1.267A–4(a)(2).

(iii) *Alternative facts—amount deemed to be an imported mismatch payment.* The facts are the same as in paragraph (c)(10)(i) of this section, except that US1 is not a domestic corporation but instead is a body corporate that is only a tax resident of Country E (hereinafter, ''FE'') (thus, for purposes of this paragraph (c)(10)(iii), the FW–US1 instrument is instead issued by FE and is the ''FW–FE instrument''). In addition, the tax law of Country E contains hybrid mismatch rules and the $50x FE pays to FW pursuant to the FW–FE instrument is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to § 1.267A–4. Pursuant to § 1.267A–4(f)(2), the $50x that FE pays to FW pursuant to the FW–FE instrument is deemed to be an imported mismatch payment for purposes of determining the extent to which the income attributable to an imported mismatch payment is offset by FW's hybrid deduction (a hybrid deduction other than one described in § 1.267A–4(f)(1)). The results are the same as in paragraphs (c)(10)(ii)(B) and (C) of this section. That is, by treating the $50x that FE pays to FW as an imported mismatch payment, and for reasons similar to those described in paragraphs (c)(10)(ii)(A) through (C) of this section, $50x of FW's $125x hybrid deduction offsets income attributable to FE's imported mismatch payment, $50x of the remaining $75x hybrid deduction offsets income attributable to US2's imported mismatch payment, and the remaining $25x hybrid deduction offsets income attributable to US3's imported mismatch payment. Accordingly, the entire $50x of US2's payment is a disqualified imported mismatch amount, and $25x of US3's payment is a disqualified imported mismatch amount.

(iv) *Alternative facts—amount deemed to be an imported mismatch payment and ''waterfall'' approach*. The facts are the same as in paragraph (c)(10)(i) of this section, except that FZ holds all of the interests of US3 indirectly through FE, a body corporate that is only a tax resident of Country E (hereinafter, ''FE''), and US3 makes its $50x payment to FE (rather than to FZ); such amount is treated as interest for Country E tax purposes and is included in FE's income. In addition, during accounting period 1, FE pays $50x to FZ pursuant to an instrument; such amount is treated as interest for Country E and Country Z tax purposes, and is included in FZ's income. Further, the tax law of Country E contains hybrid mismatch rules and the $50x FE pays to FZ pursuant to the instrument is subject to disallowance under a provision of the hybrid mismatch rules substantially similar to §1.267A–4. For purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, the $50x that FE pays to FZ is deemed to be an imported mismatch payment (and FE and FZ are deemed to be an imported mismatch payer and imported mismatch payee, respectively). *See* §1.267A–4(f)(2). With respect to US1 and US2, the results are the same as described in paragraphs (c)(10)(ii)(A) and (B) of this section. No portion of US3's payment is a disqualified imported mismatch amount because, by treating the $50x that FE pays to FZ as an imported mismatch payment, the remaining $25x of FW's hybrid deduction offsets income attributable to FE's imported mismatch payment. This is because the remaining $25x of FW's hybrid deduction is indirectly funded solely by FE's imported mismatch payment (as opposed to also being funded by US3's imported mismatch payment), as FZ (the imported mismatch payee with respect to FE's payment) directly makes a funded taxable payment to FW, whereas FE (the imported mismatch payee with respect to US3's payment) indirectly makes a funded taxable payment to FW. *See* §1.267A–4(c)(3)(ii) through (v) and (vii).

(11) *Example 11. Imported mismatch rule—hybrid deduction of a CFC*—(i) *Facts*. FX holds all the interests of US1, and FX and US1 hold 80% and 20%, respectively, of the interests of FZ, a specified party that is a CFC. US1 also holds all the interests of US2, and FX also holds all the interests of FY. FY is an entity established in Country Y, and is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes. In accounting period 1, US2 pays $100x to FZ pursuant to an instrument (the FZ–US2 instrument). The amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and is included in FZ's income; in addition, for U.S. tax purposes, the amount is foreign personal holding company income of FZ. Also in accounting period 1, FZ pays $100x to FY pursuant to an instrument (the FY–FZ instrument). The amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and none of the amount is included in FX's income. Under Country Z tax law, FZ is allowed a deduction for its entire $100x payment. Under §1.267A–2(d), the entire $100x of FZ's payment is a disqualified hybrid amount (by reason of being made to a reverse hybrid) and, as a result, a deduction for the payment is disallowed under §1.267A–1(b)(1); in addition, if a deduction were allowed for the $100x, it would be allocated and apportioned (under the rules of section 954(b)(5)) to gross subpart F income of FZ. Lastly, the FZ–US2 instrument was not entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FY–FZ instrument was entered into.

(ii) *Analysis*. US2 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(11)(ii)(A) through (C) of this section, $80x of US2's payment is a disqualified imported mismatch amount for which a deduction is disallowed under §1.267A–1(b)(2).

(A) $80x of US2's specified payment is an imported mismatch payment, calculated as $100x (the amount of the payment) less $0 (the disqualified hybrid amount with respect to the payment) less $20 (the amount of the payment that is included or includible in income in the United States). *See* § 1.267A–4(a)(2)(v). US2 is an imported mismatch payer and FZ (a foreign tax resident that includes the imported mismatch in income) is an imported mismatch payee. *See* § 1.267A–4(a)(2).

(B) But for § 1.267A–4(b)(2)(iv), the entire $100x deduction allowed to FZ under its tax law would be a hybrid deduction. *See* §§ 1.267A–2(d) and 1.267A–4(b)(1). However, pursuant to § 1.267A–4(b)(2)(iv), only $80x of the deduction is a hybrid deduction, calculated as $100x (the deduction to the extent that it would be a hybrid deduction but for § 1.267A–4(b)(2)(iv)) less $20x (the extent that FZ's payment giving rise to the deduction is a disqualified hybrid amount that is taken into account for purposes of § 1.267A–4(b)(2)(iv)(A)), less $0 (the extent that FZ's payment giving rise to the deduction is included or includible in income in the United States). *See* § 1.267A–4(b)(2)(iv). The $20x disqualified hybrid amount that is taken into account for purposes of § 1.267A–4(b)(2)(iv)(A) is calculated as $100x (the extent that FZ's payment is a disqualified hybrid amount) less $80x ($100x, the disqualified hybrid amount to the extent that, if allowed as a deduction, it would be allocated and apportioned to gross subpart F income, multiplied by 80%, the difference of 100% and the percentage of the stock (by value) of FZ that is owned by US1)). *See* § 1.267A–4(g).

(C) The $80x hybrid deduction offsets the income attributable to US2's imported mismatch payment, an imported mismatch payment that directly funds the hybrid deduction. *See* § 1.267A–4(c)(2)(ii). The entire $80x of US2's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee) incurs at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i). Accordingly, the entire $80x of US2's imported mismatch payment is a disqualified imported mismatch amount under § 1.267A–4(a)(1).

(12) *Example 12. Imported mismatch rule—application first with respect to certain hybrid deductions, then with respect to other hybrid deductions*—(i) *Facts*. FX holds all the interests of FZ, and FZ holds all the interests of each of US1 and FE. The tax law of Country E contains hybrid mismatch rules. FX holds an instrument issued by FZ that is treated as equity for Country X tax purposes and indebtedness for Country Z tax purposes (the FX–FZ instrument). In accounting period 1, FZ pays $10x to FX pursuant to the FX–FZ instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country Z tax purposes. Also in accounting period 1, FZ is allowed a $90x notional interest deduction with respect to its equity under Country Z tax law. In addition, in accounting period 1, US1 pays $100x to FZ pursuant to an instrument (the FZ–US1 instrument); the amount is treated as interest for U.S. tax purposes and Country Z tax purposes, and is included in FZ's income. Further, in accounting period 1, FE pays $40x to FZ pursuant to an instrument (the FZ–FE instrument); the amount is treated as interest for Country E and Country Z tax purposes, is included in FZ's income, and is subject to disallowance under a provision of Country E hybrid mismatch rules substantially similar to § 1.267A–4. Lastly, neither the FZ–US1 instrument nor the FZ–FE instrument was entered into pursuant to a plan or series of related transactions that includes the transaction pursuant to which the FX–FZ instrument was entered into.

(ii) *Analysis*. US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(12)(ii)(A) through (D) of this section, $92x of US1's payment is a disqualified imported mismatch amount for which a deduction is disallowed under § 1.267A–1(b)(2).

(A) The entire $100x of US1's specified payment is an imported mismatch payment. *See* § 1.267A–4(a)(2)(v). US1 is an imported mismatch payer and FZ (a foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. *See* § 1.267A–4(a)(2).

(B) FZ has $100x of hybrid deductions (the $10x deduction for the payment pursuant to the FX–FZ instrument plus the $90x notional interest deduction). *See* § 1.267A–4(b). Pursuant to § 1.267A–4(f)(1), § 1.267A–4 is first applied by taking into account only the $90x hybrid deduction consisting of the notional interest deduction; in addition, for purposes of applying § 1.267A–4 in this manner, FE's $40x payment is not treated as an imported mismatch payment. Thus, the $90x hybrid deduction offsets the income attributable to US1's imported mismatch payment, an imported mismatch payment that directly funds the hybrid deduction. *See* § 1.267A–4(c)(2)(ii). Moreover, $90x of US1's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee) incurs at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i).

(C) Section § 1.267A–4 is next applied by taking into account only the $10x hybrid deduction consisting of the deduction for the payment pursuant to the FX–FZ instrument. *See* § 1.267A–4(f)(2). When applying § 1.267A–4 in this manner, and for purposes of determining the extent to which the income attributable to an imported mismatch payment is directly or indirectly offset by a hybrid deduction, FE's $40x payment is treated as an imported mismatch payment. *See* § 1.267A–4(f)(2). In addition, US1's imported mismatch payment is reduced from $100x to $10x. *See* § 1.267A–4(c)(4). But for FE's imported mismatch payment, the entire $10x of US1's imported mismatch payment would directly fund the $10x hybrid deduction because FZ incurred at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i). Similarly, but for US1's imported mismatch payment, the entire $40x of FE's imported mismatch payment would directly fund the $10x hybrid deduction because FZ incurred at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i). However, because the sum of US1's and FE's imported mismatch payments to FZ ($50x) exceeds the hybrid deduction incurred by FZ ($10x), pro rata adjustments must be made. *See* § 1.267A–4(e). Thus, $2x of US1's imported mismatch payment is considered to directly fund the hybrid deduction, calculated as $10x (the amount of the hybrid deduction) multiplied by 20% ($10x, the amount of US1's imported mismatch payment to FZ, divided by $50x, the sum of the imported mismatch payments that US1 and FE make to FZ). Similarly, $8x of FE's imported mismatch payment is considered to directly fund the hybrid deduction, calculated as $10x (the amount of the hybrid deduction) multiplied by 80% ($40x, the amount of FE's imported mismatch payment to FZ, divided by $50x, the sum of the imported mismatch payments that US1 and FE make to FZ). Accordingly, $2x of FZ's $10x hybrid deduction offsets income attributable to US1's $10x imported mismatch payment, and $8x of the hybrid deduction offsets income attributable to FE's $40x imported mismatch payment.

(D) Therefore, $92x of US1's imported mismatch payment is a disqualified imported mismatch amount, calculated as $90x (the amount that is a disqualified imported mismatch amount determined by applying § 1.267A–4 in the manner set forth in § 1.267A–4(f)(1)) plus $2x (the amount that is a disqualified imported mismatch amount determined by applying § 1.267A–4 in the manner set forth in § 1.267A–4(f)(2)). *See* § 1.267A–4(a)(1) and (f).

(iii) *Alternative facts—amount deemed to be an imported mismatch payment solely funds hybrid instrument deduction.* The facts are the same as in paragraph (c)(12)(i) of this section, except that FZ holds all of the interests of US1 indirectly through FE, and US1 makes its $100x payment to FE (rather than to FZ); such amount is treated as interest for U.S. and Country E tax purposes, and is included in FE's income. Moreover, FE pays $100x to FZ (rather than $40x); such amount is included in FZ's income, and is subject to disallowance under a provision of Country E hybrid mismatch rules substantially similar to § 1.267A–4. As described in paragraphs (c)(12)(iii)(A) through (D) of this section, $90x of US1's payment is a disqualified imported mismatch amount for which a deduction is disallowed under § 1.267A–1(b)(2).

(A) The entire $100x of US1's specified payment is an imported mismatch payment. *See* § 1.267A–4(a)(2)(v). US1 is an imported mismatch payer and FE (a foreign tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. *See* § 1.267A–4(a)(2).

(B) FZ has $100x of hybrid deductions. *See* § 1.267A–4(b). Pursuant to § 1.267A–4(f)(1), § 1.267A–4 is first applied by taking into account only the $90x hybrid deduction consisting of the notional interest deduction; in addition, for purposes of applying § 1.267A–4 in this manner, FE's $100x payment is not treated as an imported mismatch payment. Thus, the $90x hybrid deduction offsets the income attributable to US1's imported mismatch payment, an imported mismatch payment that indirectly funds the hybrid deduction. *See* § 1.267A–4(c)(2)(iii). The imported mismatch payment indirectly funds the hybrid deduction because FE (the imported mismatch payee) is allocated the deduction, as FE makes a funded taxable payment (the $100x payment to FZ) that is at least equal to the amount of the deduction. *See* § 1.267A–4(c)(3)(ii), (iii), and (v).

(C) Section § 1.267A–4 is next applied by taking into account only the $10x hybrid deduction consisting of the deduction for the payment pursuant to the FX–FZ instrument. *See* § 1.267A–4(f)(2). For purposes of applying § 1.267A–4 in this manner, FE's $100x payment is reduced from $100x to $10x, and similarly US1's imported mismatch payment is reduced from $100x to $10x. *See* § 1.267A–4(c)(4). Further, FE's $10x payment is treated as an imported mismatch payment. *See* § 1.267A–4(f)(2). The entire $10x of FE's imported mismatch payment directly funds the hybrid deduction because FZ (the imported mismatch payee with respect to FE's imported mismatch payment) incurs at least that amount of the hybrid deduction. *See* § 1.267A–4(c)(3)(i). Accordingly, the $10x hybrid deduction offsets the income attributable to FE's imported mismatch payment, and none of the income attributable to US1's imported mismatch payment.

(D) Therefore, $90x of US1's imported mismatch payment is a disqualified imported mismatch amount, calculated as $90x (the amount that is a disqualified imported mismatch amount determined by applying § 1.267A–4 in the manner set forth in § 1.267A–4(f)(1)) plus $0 (the amount that is a disqualified imported mismatch amount determined by applying § 1.267A–4 in the manner set forth in § 1.267A–4(f)(2)). *See* § 1.267A–4(a)(1) and (f).

[T.D. 9896, 85 FR 19836, Apr. 8, 2020]

§ 1.267A–7 Applicability dates.

(a) *General rule.* Except as provided in paragraph (b) of this section, §§ 1.267A–1 through 1.267A–6 apply to taxable years ending on or after December 20, 2018, provided that such taxable years begin after December 31, 2017. However, taxpayers may apply the regulations in §§ 1.267A–1 through 1.267A–6 in their entirety (including by taking into account paragraph (b) of this section) for taxable years beginning after December 31, 2017, and ending before December 20, 2018. In lieu of applying the regulations in §§ 1.267A–1 through 1.267A–6 (including paragraph (b) of this section), taxpayers may apply the provisions matching §§ 1.267A–1 through 1.267A–6 (including by taking into account the provision matching paragraph (b) of this section) from the Internal Revenue Bulletin (IRB) 2019–03 (*https://www.irs.gov/pub/irs-irbs/irb19-03.pdf*) in their entirety for all taxable years ending on or before April 8, 2020.

(b) *Special rules.* The following special rules apply regarding applicability dates:

(1) Sections 1.267A–2(a)(4) (payments pursuant to interest-free loans and similar arrangements), (b) (disregarded payments), (c) (deemed branch payments), and (e) (branch mismatch transactions), 1.267A–4 (imported mismatch rule), and 1.267A–5(b)(5) (structured payments), except as provided in paragraph (b)(5) of this section, apply to taxable years beginning on or after December 20, 2018.

(2) Section 1.267A–5(a)(20) (defining structured arrangement), as well as the portions of §§ 1.267A–1 through 1.267A–3 that relate to structured arrangements and that are not otherwise described in paragraph (b) of this section, apply to taxable years beginning on or after December 20, 2018. However, in the case of a specified payment made pursuant to an arrangement entered into before December 22, 2017, § 1.267A–5(a)(20), and the portions of §§ 1.267A–1 through

1.267A–3 that relate to structured arrangements and that are not otherwise described in paragraph (b) of this section, apply to taxable years beginning after December 31, 2020.

(3) Except as provided in paragraph (b)(4) of this section, the rules provided in §1.267A–5(a)(12)(ii) (swaps with significant nonperiodic payments) apply to notional principal contracts entered into on or after April 8, 2021. However, taxpayers may apply the rules provided in §1.267A–5(a)(12)(ii) to notional principal contracts entered into before April 8, 2021.

(4) For a notional principal contract entered into before April 8, 2021, the interest equivalent rules provided in §1.267A–5(b)(5)(ii)(B) (applied without regard to the references to §1.267A–5(a)(12)(ii)) apply to a notional principal contract entered into on or after April 8, 2020.

(5) Section 1.267A–5(b)(5)(ii)(B) (interest equivalent rules) applies to transactions entered into on or after April 8, 2020.

[T.D. 9896, 85 FR 19836, Apr. 8, 2020, as amended by 85 FR 48651, Aug. 12, 2020]

§ 1.267(a)–1 Deductions disallowed.

(a) *Losses.* Except in cases of distributions in corporate liquidations, no deduction shall be allowed for losses arising from direct or indirect sales or exchanges of property between persons who, on the date of the sale or exchange, are within any one of the relationships specified in section 267(b). See §1.267(b)–1.

(b) *Unpaid expenses and interest.* (1) No deduction shall be allowed a taxpayer for trade or business expenses otherwise deductible under section 162, for expenses for production of income otherwise deductible under section 212, or for interest otherwise deductible under section 163:

(i) If, at the close of the taxpayer's taxable year within which such items are accrued by the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the payee are persons within any one of the relationships specified in section 267(b) (see §1.267(b)–1); and

(ii) If the payee is on the cash receipts and disbursements method of accounting with respect to such items of gross income for his taxable year in which or with which the taxable year of accrual by the debtor-taxpayer ends; and

(iii) If, within the taxpayer's taxable year within which such items are accrued by the taxpayer and 2½ months after the close thereof, the amount of such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267(a)(2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267(a)(2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accruable.

(3) The expenses and interest specified in section 267(a)(2) and this paragraph shall be considered as paid for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2½ months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

(4) The provisions of this paragraph may be illustrated by the following example:

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446(c)(4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year

1956 or within 2½ months after the close of that year, nor does it credit any interest to A's account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corporation claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of gross income, the interest is not includible in his return for the year 1956. Under the provisions of section 267(a)(2) and this paragraph, no deduction for such interest is allowable in computing the taxable income of the M Corporation for the taxable year 1956 or for any other taxable year. However, if the interest had actually been paid to A on or before March 15, 1957, or if it had been made available to A before that time (and thus had been constructively received by him), the M Corporation would be allowed to deduct the amount of the payment in computing its taxable income for 1956.

(c) *Scope of section.* Section 267(a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction. However, section 267 is not exclusive. No deduction for losses or unpaid expenses or interest arising in a transaction which is not bona fide will be allowed even though section 267 does not apply to the transaction.

§ 1.267(a)–2T Temporary regulations; questions and answers arising under the Tax Reform Act of 1984 (temporary).

(a) *Introduction*—(1) *Scope.* This section prescribes temporary question and answer regulations under section 267(a) and related provisions as amended by section 174 of the Tax Reform Act of 1984, Pub. L. No. 98–369.

(2) *Effective date.* Except as otherwise provided by *Answer 2* or *Answer 3* in paragraph (c) of this section, the effective date set forth in section 174(c) of the Tax Reform Act of 1984 applies to this section.

(b) *Questions applying section 267(a)(2) and (b) generally.* The following questions and answers deal with the application of section 267(a)(2) and (b) generally:

Question 1: Does section 267(a)(2) ever apply to defer the deduction of an otherwise deductible amount if the person to whom the payment is to be made properly uses the completed contract method of accounting with respect to such amount?

Answer 1: No. Section 267(a)(2) applies only if an otherwise deductible amount is owed to a related person under whose method of accounting such amount is not includible in income unless paid to such person. Regardless of when payment is made, an amount owed to a contractor using the completed contract method of accounting is includible in the income of the contractor in accordance with § 1.451–3(d) in the year in which the contract is completed or in which certain disputes are resolved.

Question 2: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible original issue discount as defined in sections 163(e) and 1271 through 1275 (''the OID rules'')?

Answer 2. No. Regardless of when payment is made, an amount owed to a lender that constitutes original issue discount is included in the income of the lender periodically in accordance with the OID rules. Similarly, section 267(a)(2) does not apply to defer an otherwise deductible amount to the extent section 467 or section 7872 requires periodic inclusion of such amount in the income of the person to whom payment is to be made, even though payment has not been made.

Question 3: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible unstated interest determined to exist under section 483?

Answer 3: Yes. If section 483 recharacterizes any amount as unstated interest and the other requirements of section 267(a)(2) are met, a deduction for such unstated interest will be deferred under section 267.

Question 4: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization?

Answer 4: Yes, in certain cases. In general, section 267(a)(2) does not apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization. Notwithstanding this general rule, if the other requirements of section 267(a)(2) are met, section 267(a)(2) does apply to defer deductions for cost recovery, depreciation, or amortization of an amount owed to a related person for interest or rent or for the performance or nonperformance of services, which amount the taxpayer payor capitalized or treated as a deferred expense (unless the taxpayer payor elected to capitalize or defer the amount and section 267(a)(2) would not have deferred the deduction of such amount if the taxpayer payor had not so elected). Amounts owed for services that may be subject to this provision include, for example, amounts owed for acquisition, development, or organizational services or for covenants not to compete. In applying this rule, payments made between persons described in any of the paragraphs of section 267(b) (as modified by section 267(e)) will be closely scrutinized to determine whether they are made in respect of capitalized costs (or costs treated as deferred expenses) that are subject to deferral under section 267(a)(2), or in respect of other capitalized costs not so subject.

Question 5: If a deduction in respect of an otherwise deductible amount is deferred by section 267(a)(2) and, prior to the time the amount is includible in the gross income of the person to whom payment is to be made, such person and the payor taxpayer cease to be persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e)), is the deduction allowable as of the day on which the relationship ceases?

Answer 5: No. The deduction is not allowable until the day as of which the amount is includible in the gross income of the person to whom payment of the amount is made, even though the relationship ceases to exist at an earlier time.

Question 6: Do references in other sections to persons described in section 267(b) incorporate changes made to section 267(b) by section 174 of the Tax Reform Act of 1984?

Answer 6: Yes. References in other sections to persons described in section 267(b) take into account changes made to section 267(b) by section 174 of the Tax Reform Act of 1984 (without modification by section 267(e)(1)). For example, a transfer after December 31, 1983 (the effective date of the new section 267(b)(3) relationship added by the Tax Reform Act of 1984) of section 1245 class property placed in service before January 1, 1981, from one corporation to another corporation, 11 percent of the stock of which is owned by the first corporation, will not constitute recovery property (as defined in section 168) in the hands of the second corporation by reason of section 168(e)(4) (A)(i) and (D).

(c) *Questions applying section 267(a) to partnerships.* The following questions and answers deal with the application of section 267(a) to partnerships:

Question 1: Does section 267(a) disallow losses and defer otherwise deductible amounts at the partnership (entity) level?

Answer 1: Yes. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss shall not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount shall not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

Question 2: Does section 267(a)(1) ever apply to disallow a loss if the sale or exchange giving rise to the loss is between two partnerships even though the two partnerships are not persons specified in any of the paragraphs of section 267(b)?

Answer 2: Yes. If the other requirements of section 267(a)(1) are met, section 267(a)(1) applies to such losses arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) as follows, and §1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (*i.e.*, if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the selling partnership's loss will be disallowed under section 267(a)(1). The amount disallowed under this rule is the greater of: (1) The amount that would be disallowed if the transaction giving rise to the loss had occurred between the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership (in proportion to their respective interests in the selling partnership) and the purchasing partnership. Notwithstanding the general rule of this paragraph (c) *Answer 2*, no disallowance shall occur if the amount that would be disallowed pursuant to the immediately preceding sentence is less than 5 percent of the loss arising from the sale or exchange.

Question 3: Does section 267(a)(2) ever apply to defer an otherwise deductible amount if the taxpayer payor is a partnership and the person to whom payment of such amount is to be made is a partnership even though the two partnerships are not persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e))?

Answer 3: Yes. If the other requirements of section 267(a)(2) are met, section 267(a)(2) applies to such amounts arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) (as modified by section 267(e)) as follows, and §1.267(b)–1(b) does not apply. If the two partnerships have one or more common partners (*i.e.*, if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the payor partnership's otherwise allowable deduction will be deferred under section 267(a)(2). The amount deferred under this rule is the greater of: (1) The amount that would be deferred if the transaction giving rise to the otherwise allowable deduction had occurred between the payor partnership and the separate partners of the payee partnership (in proportion to their respective interests in the payee partnership); or (2) the amount that would be deferred if such transaction had occurred between the separate partners of the payor partnership (in proportion to their respective interests in the payor partnership) and the payee partnership. Notwithstanding the general rule of this paragraph (c) *Answer 3*, no deferral shall occur if the amount that would be deferred pursuant to the immediately preceding sentence is less than 5 percent of the otherwise allowable deduction.

Example. On May 1, 1985, partnership AB enters into a transaction whereby it accrues an otherwise deductible amount to partnership AC. AC is on the cash receipts and disbursements method of accounting. A holds a 5 percent capital and profits interest in AB and a 49 percent capital and profits interest in AC, and A's interest in each item of the income, gain, loss, deduction, and credit of each partnership is 5 percent and 49 percent, respectively. B and C are not related. Notwithstanding that AB and AC are not persons specified in section 267(b), 49 percent of the deduction in respect of such amount will be deferred under section 267(a)(2). The result would be the same if A held a 49 percent interest in AB and a 5 percent interest in AC. However, if A held more than 50 percent of the capital or profits interest of either AB or AC, the entire deduction in respect of such amount would be deferred under section 267(a)(2).

Question 4: What does the phrase *incurred at an annual rate not in excess of 12 percent* mean as used in section 267(e)(5)(C)(ii)?

Answer 4: The phrase refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum, compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be made no later than the last day of such taxable year of the payor taxpayer.

(98 Stat. 704, 26 U.S.C. 267; 98 Stat. 589, 26 U.S.C. 706; 68A Stat. 367, 26 U.S.C. 1502; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7991, 49 FR 46995, Nov. 30, 1984]

§ 1.267(a)–3 Deduction of amounts owed to related foreign persons.

(a) *Purpose and scope.* This section provides rules under section 267(a) (2) and (3) governing when an amount owed to a related foreign person that is otherwise deductible under Chapter 1 may be deducted. Paragraph (b) of this section provides the general rules, and paragraph (c) of this section provides exceptions and special rules.

(b) *Deduction of amount owed to related foreign person*—(1) *In general.* Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the taxpayer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines *controlled group* for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).

(2) *Amounts covered.* This section applies to otherwise deductible amounts that are of a type described in section 871(a)(1) (A), (B) or (D), or in section 881(a) (1), (2) or (4). The rules of this section also apply to interest that is from sources outside the United States. Amounts other than interest that are from sources outside the United States, and that are not income of a related foreign person effectively connected with the conduct by such related foreign person of a trade or business within the United States, are not subject to the rules of section 267(a) (2) or (3) or this section. See paragraph (c) of this section for rules governing the treatment of amounts that are income of a related foreign person effectively connected with the conduct of a trade or business within the United States by such related foreign person.

(3) *Change in method of accounting.* A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer's change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of taxpayer's earnings and profits pursuant to §1.1312–6(a).

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

Example 1. (i) FC, a corporation incorporated in Country X, owns 100 percent of the stock of C, a domestic corporation. C uses the accrual method of accounting in computing its income and deductions, and is a calendar year taxpayer. In Year 1, C accrues an amount owed to FC for interest. C makes an actual payment of the amount owed to FC in Year 2.

(ii) Regardless of its source, the interest owed to FC is an amount to which this section applies. Pursuant to the rules of this paragraph (b), the amount owed to FC by C will not be allowable as a deduction in Year 1. Section 267 does not preclude the deduction of this amount in Year 2.

Example 2. (i) RS, a domestic corporation, is the sole shareholder of FSC, a foreign sales corporation. Both RS and FSC use the accrual method of accounting. In Year 1, RS accrues $z owed to FSC for commissions earned by FSC in Year 1. Pursuant to the foreign sales company provisions, sections 921 through 927, a portion of this amount, $x, is treated as effectively connected income of FSC from sources outside the United States. Accordingly, the rules of section 267(a)(3) and paragraph (b) of this section do not apply. See paragraph (c) of this section for the rules governing the treatment of amounts that are effectively connected income of FSC.

(ii) The remaining amount of the commission, $y, is classified as exempt foreign trade income under section 923(a)(3) and is treated as income of FSC from sources outside the United States that is not effectively connected income. This amount is one to which the provisions of this section do not apply, since it is an amount other than interest from sources outside the United States and is not effectively connected income. Therefore, a deduction for $y is allowable to RS as of the day on which it accrues the otherwise deductible amount, without regard to section 267 (a)(2) and (a)(3) and the regulations thereunder.

(c) *Exceptions and special rules*—(1) *Effectively connected income subject to United States tax*. The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (b) of this section, apply to an amount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (c)(1) thus is allowable as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (c)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) *Items exempt from tax by treaty*. Except with respect to interest, neither paragraph (b) of this section nor section 267 (a)(2) applies to any amount that is income of a related foreign person with respect to which the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits). Interest that is effectively connected income of the related foreign person under sections 872(a)(2) or 882(b) is an amount covered by paragraph (c)(1) of this section. Interest that is not effectively connected income of the related foreign person is an amount covered by paragraph (b) of this section, regardless of whether the related foreign person is exempt from United States taxation on the amount owed pursuant to a treaty obligation of the United States.

(3) *Items subject to reduced rate of tax by treaty*. Paragraph (b) of this section applies to amounts that are income of a related foreign person with respect to which the related foreign person claims a reduced rate of United States income tax on the amount owed pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of royalties).

(4) *Certain amounts owed to certain controlled foreign corporations*. An amount that is income of a related foreign person is exempt from the application of section 267(a)(3)(B)(i) if the related foreign person is a controlled foreign corporation that does not have any United States shareholders (as defined in section 951(b)) that own (within the meaning of section 958(a)) stock of the controlled foreign corporation. However, in this case, the amount is subject to the application of section 267(a)(3)(A) in the same manner as if the related foreign person were a foreign corporation that is not a controlled foreign corporation.

(d) *Effective date*. The rules of this section are effective with respect to interest that is allowable as a deduction under chapter 1 (without regard to the rules of this section) in taxable years beginning after December 31, 1983, but are not effective with respect to interest that is incurred with respect to indebtedness incurred on or before September 29, 1983, or incurred after that date pursuant to a contract that was binding on that date and at all times thereafter (unless the indebtedness or the contract was renegotiated, extended, renewed, or revised after that date). Except as otherwise provided in this paragraph (d), the regulations in this section issued under section 267 apply to all other deductible amounts that are incurred after July 31, 1989, but do not apply to amounts that are incurred pursuant to a contract that was binding on September 29, 1983, and at all times thereafter (unless the contract was renegotiated, extended, renewed, or revised after that date). Paragraph (c)(2) of this section applies to payments accrued on or after October 22, 2004. For payments accrued before October 22, 2004, see §1.267(a)–3(c)(2), as contained in 26 CFR part 1, revised as of April 1, 2004. Paragraph (c)(4) of this section applies to payments accrued on or after October 1, 2019. For payments accrued before October 1, 2019, a taxpayer may apply paragraph (c)(4) of this section for payments accrued during the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, provided that the taxpayer and United States persons that are related (within the meaning of section 267 or 707) to the taxpayer consistently apply such paragraph with respect to all foreign corporations. For payments accrued before October 22, 2004, see §1.267(a)–3(c)(4), as contained in 26 CFR part 1, revised as of April 1, 2004.

[T.D. 8465, 58 FR 237, Jan. 5, 1993, as amended by T.D 9908, 85 FR 59430, Sept. 22, 2020]

§ 1.267(b)–1 Relationships.

(a) *In general.* (1) The persons referred to in section 267(a) and §1.267 (a)–1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as defined in section 267(c)(4) and paragraph (a)(4) of §1.267 (c)–1, shall be taken into account.

(b) *Partnerships.* (1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and §1.707–1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed:

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

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

Example 1. A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2½ months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267 (a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such deductions. See section 705(a)(2).

Example 2. Assume the same facts as in *Example 1* of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2½ months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest is not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

§ 1.267(c)–1 Constructive ownership of stock.

(a) *In general.* (1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267(c)(2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under section 267(c)(1), by or for his partner, such individual must himself actually own, or constructively own under section 267(c)(1), stock of such corporation.

(3) An individual's constructive ownership, under section 267(c) (2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term *ancestors* includes parents and grandparents, and the term *lineal descendants* includes children and grandchildren.

(b) *Examples.* The application of section 267(c) may be illustrated by the following examples:

Example 1. On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

Person	Stock ownership in M Corporation		Total under Section 267 (Percent)	Stock ownsership in O Corporation		Total under Section 267 (Percent)
	Actual (Percent)	Constructive (Percent)		Actual (Percent)	Constructive (Percent)	
A	75	25	100	None	60 20	80
A W (A's wife)	25	75	100	None	20 60	80
A W F (AW's father)	None	25	25	None	20	20
M Corporation	....	....	....	80	None	80
O Corporation	None	None	None	....	....	....

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that other corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

Example 2. On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

Example 3. On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267(a) (except for distributions in liquidation of X Corporation).

§ 1.267(d)–1 Amount of gain where loss previously disallowed.

(a) *General rule.* (1) If a taxpayer acquires property by purchase or exchange from a transferor who, on the transaction, sustained a loss not allowable as a deduction by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), then any gain realized by the taxpayer on a sale or other disposition of the property after December 31, 1953, shall be recognized only to the extent that the gain exceeds the amount of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

(2) The general rule is also applicable to a sale or other disposition of property by a taxpayer when the basis of such property in the taxpayer's hands is determined directly or indirectly by reference to other property acquired by the taxpayer from a transferor through

a sale or exchange in which a loss sustained by the transferor was not allowable. Therefore, section 267(d) applies to a sale or other disposition of property after a series of transactions if the basis of the property acquired in each transaction is determined by reference to the basis of the property transferred, and if the original property was acquired in a transaction in which a loss to a transferor was not allowable by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939).

(3) The benefit of the general rule is available only to the original transferee but does not apply to any original transferee (for example, a donee or a person acquiring property from a decedent where the basis of property is determined under section 1014 or 1022) who acquired the property in any manner other than by purchase or exchange.

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

Example 1. H sells to his wife, W, for $500, certain corporate stock with an adjusted basis for determining loss to him of $800. The loss of $300 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of §1.267 (a)–1. W later sells this stock for $1,000. Although W's realized gain is $500 ($1,000 minus $500, her basis), her recognized gain under section 267(d) is only $200, the excess of the realized gain of $500 over the loss of $300 not allowable to H. In determining capital gain or loss W's holding period commences on the date of the sale from H to W.

Example 2. Assume the same facts as in *Example 1* except that W later sells her stock for $300 instead of $1,000. Her recognized loss is $200 and not $500 since section 267(d) applies only to the nonrecognition of gain and does not affect basis.

Example 3. Assume the same facts as in *Example 1* except that W transfers her stock as a gift to X. The basis of the stock in the hands of X for the purpose of determining gain, under the provisions of section 1015, is the same as W's, or $500. If X later sells the stock for $1,000 the entire $500 gain is taxed to him.

Example 4. H sells to his wife, W, for $5,500, farmland, with an adjusted basis for determining loss to him of $8,000. The loss of $2,500 is not allowable to H by reason of section 267(a)(1) and paragraph (a) of §1.267 (a)–1. W exchanges the farmland, held for investment purposes, with S, an unrelated individual, for two city lots, also held for investment purposes. The basis of the city lots in the hands of W ($5,500) is a substituted basis determined under section 1031(d) by reference to the basis of the farmland. Later W sells the city lots for $10,000. Although W's realized gain is $4,500 (10,000 minus $5,500), her recognized gain under section 267(d) is only $2,000, the excess of the realized gain of $4,500 over the loss of $2,500 not allowable to H.

(b) *Determination of basis and gain with respect to divisible property*—(1) *Taxpayer's basis.* When the taxpayer acquires divisible property or property that consists of several items or classes of items by a purchase or exchange on which loss is not allowable to the transferor, the basis in the taxpayer's hands of a particular part, item, or class of such property shall be determined (if the taxpayer's basis for that part is not known) by allocating to the particular part, item, or class a portion of the taxpayer's basis for the entire property in the proportion that the fair market value of the particular part, item, or class bears to the fair market value of the entire property at the time of the taxpayer's acquisition of the property.

(2) *Taxpayer's recognized gain.* Gain realized by the taxpayer on sales or other dispositions after December 31, 1953, of a part, item, or class of the property shall be recognized only to the extent that such gain exceeds the amount of loss attributable to such part, item, or class of property not allowable to the taxpayer's transferor on the latter's sale or exchange of such property to the taxpayer.

(3) *Transferor's loss not allowable.* (i) The transferor's loss on the sale or exchange of a part, item, or class of the property to the taxpayer shall be the excess of the transferor's adjusted basis for determining loss on the part, item, or class of the property over the amount realized by the transferor on the sale or exchange of the part, item, or class. The amount realized by the transferor on the part, item, or class shall be determined (if such amount is not known) in the same manner that the taxpayer's basis for such part, item, or class is determined. See subparagraph (1) of this paragraph.

(ii) If the transferor's basis for determining loss on the part, item, or class cannot be determined, the transferor's loss on the particular part, item, or class transferred to the taxpayer shall be determined by allocating to the part, item, or class a portion of his loss on the entire property in the proportion that the fair market value of such part, item, or class bears to the fair market value of the entire property on the date of the taxpayer's acquisition of the entire property.

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

Example 1. During 1953, H sold class A stock which had cost him $1,100, and common stock which had cost him $2,000, to his wife W for a lump sum of $1,500. Under section 24(b)(1)(A) of the 1939 Code, the loss of $1,600 on the transaction was not allowable to H. At the time the stocks were purchased by W, the fair market value of class A stock was $900 and the fair market value of common stock was $600. In 1954, W sold the class A stock for $2,500. W's recognized gain is determined as follows:

Amount realized by W on sale of class A stock		$2,500
Less: Basis allocated to class A stock—$900/ $1,500 × $1,500		900
Realized gain on transaction		1,600
Less: Loss sustained by H on sale of class A stock to W not allowable as a deduction:		
Basis to H of class A stock	$1,100	
Amount realized by H on class A stock—$900/ $1,500 × $1,500	900	
Unallowable loss to H on sale of class A stock		200
Recognized gain on sale of class A stock by W		1,400

Example 2. Assume the same facts as those stated in *Example 1* of this subparagraph except that H originally purchased both classes of stock for a lump sum of $3,100. The unallowable loss to H on the sale of all the stock to W is $1,600 ($3,100 minus $1,500). An exact determination of the unallowable loss sustained by H on sale to W of class A stock cannot be made because H's basis for class A stock cannot be determined. Therefore, a determination of the unallowable loss is made by allocating to class A stock a portion of H's loss on the entire property transferred to W in the proportion that the fair market value of class A stock at the time acquired by W ($900) bears to the fair market value of both classes of stock at that time ($1,500). The allocated portion is $900/$1,500 × $1,600, or $960. W's recognized gain is, therefore, $640 (W's realized gain of $1,600 minus $960).

(c) *Special rules.* (1) Section 267(d) does not affect the basis of property for determining gain. Depreciation and other items which depend on such basis are also not affected.

(2) The provisions of section 267(d) shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091, or section 118 of the Internal Revenue Code of 1939, which relate to losses from wash sales of stock or securities.

(3) In determining the holding period in the hands of the transferee of property received in an exchange with a transferor with respect to whom a loss on the exchange is not allowable by reason of section 267, section 1223(2) does not apply to include the period during which the property was held by the transferor. In determining such holding period, however, section 1223(1) may apply to include the period during which the transferee held the property which he exchanged where, for example, he exchanged a capital asset in a transaction which, as to him, was nontaxable under section 1031 and the property received in the exchange has the same basis as the property exchanged.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 9811, 82 FR 6237, Jan. 19, 2017]

§ 1.267(d)–2 Effective/applicability dates.

Pursuant to section 7851(a)(1)(C), the regulations prescribed in § 1.267(d)–1, to the extent that they relate to determination of gain resulting from the sale or other disposition of property after December 31, 1953, with respect to which property a loss was not allowable to the transferor by reason of section 267(a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939), shall also apply to taxable years beginning before January 1, 1954, and ending after December 31, 1953, and taxable years beginning after December 31, 1953, and ending before August 17, 1954, which years are subject to the Internal Revenue Code of 1939. The provisions of § 1.267(d)–1(a)(3) relating to section 1022 are effective on and after January 19, 2017.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 9811, 82 FR 6237, Jan. 19, 2017]

§ 1.267(f)–1 Controlled groups.

(a) *In general*—(1) *Purpose*. This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) *Application of consolidated return principles*. Under this section, S's loss or deduction from an intercompany sale is taken into account under the *timing* principles of § 1.1502–13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of § 1.1502–13 (c) and (d), the definitions and operating rules of § 1.1502–13 (b) and (j), and the simplifying rules of § 1.1502–13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section—

(A) Applies on a controlled group basis rather than consolidated group basis; and

(B) Generally affects only the *timing* of a loss or deduction, and not *it's attributes* (*e.g.*, *its source* and *character*) or the holding period of property.

(ii) The special rules under § 1.1502–13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which § 1.1502–13 applies.

(iii) Any election under § 1.1502–13 to take items into account on a separate entity basis does not apply under this section. See § 1.1502–13(e)(3).

(3) *Other law*. The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, to the extent a loss or deduction deferred under this section is from a transaction that is also an intercompany transaction under § 1.1502–13(b)(1), attributes of the loss or deduction are also subject to recharacterization under § 1.1502–13. See also, sections 269 (acquisitions to evade or avoid income tax) and 482 (allocations among commonly controlled taxpayers). Any loss or deduction taken into account under this section can be deferred, disallowed, or eliminated under other applicable law. See, for example, section 1091 (loss eliminated on wash sale).

(b) *Definitions and operating rules*. The definitions in § 1.1502–13(b) and the operating rules of § 1.1502–13(j) apply under this section with appropriate adjustments, including the following:

(1) *Intercompany sale*. An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of § 1.1502–13, determined by treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) *S's losses or deductions*. Except to the extent the intercompany sale is also an intercompany transaction to which § 1.1502–13 applies, S's losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of § 1.1502–13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) *Controlled group; member*. For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563(b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in § 1.1502–13(j)(7)). Further, the principles of § 1.1502–13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member

of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) *Consolidated taxable income.* References to consolidated taxable income (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) *Matching and acceleration principles of §1.1502–13*—(1) *Adjustments to the timing rules.* Under this section, S's losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of §1.1502–13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S's loss is deferred and taken into account under the principles of the matching rule of §1.1502–13(c) to reflect the difference between B's depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S's remaining loss is taken into account under the principles of the acceleration rule of §1.1502–13(d). For purposes of this section, the adjustments to §1.1502–13 (c) and (d) include the following:

(i) *Application on controlled group basis.* The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S's loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated group. Similarly, S's loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) *Different taxable years.* If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.

(iii) *Transfer to a section 267(b) or 707(b) related person.* To the extent S's loss or deduction from an intercompany sale of property is taken into account under this section as a result of B's transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) *B's item is excluded from gross income or noncapital and nondeductible.* To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13, but is not redetermined under paragraph (c)(2) of this section (which generally renders the attribute redetermination rule inapplicable to sales between members of a controlled group), S's loss continues to be deferred. For purposes of this paragraph, stock held by S, stock held by B, stock held by all members of S's consolidated group, stock held by any member of a controlled group of which S is a member that was acquired from a member of S's consolidated group, and stock issued by T to a member of the controlled group must be taken into account in determining whether a loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13. If the loss remains deferred, it is taken into account when S and B (including their successors) are no longer in a controlled group relationship. (If, however, the property is transferred to certain related persons, paragraph (c)(1)(iii) of this section will cause the loss to be permanently disallowed.) For example, if S sells all of the T stock to B at a loss (in a transaction that is treated as a sale or exchange for Federal income tax purposes), and T subsequently liquidates in an unrelated transaction that qualifies under section 332, S's loss is deferred until S and B are no longer in a controlled group relationship. Similarly, if S owns all of the T stock and sells 30 percent of T's stock to B at a loss (in a transaction that is treated as a sale or exchange for Federal income tax purposes), and T subsequently liquidates, S's loss on the sale is deferred until S and B (including their successors) are no longer in a controlled group relationship.

(v) *Circularity of references.* References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., §1.1502–13(a)(4) (applicability of other law).

(2) *Attributes generally not affected.* The matching and acceleration rules are not applied under this section to affect the attributes of S's intercompany item, or cause it to be taken into account before it is taken into account under S's separate entity method of accounting. However, the attributes of S's intercompany item may be redetermined, or an item may be taken into account earlier than under S's separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies. Similarly, except to the extent the transaction is also an intercompany transaction to which §1.1502–13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B's corresponding items.

(d) *Intercompany sales of inventory involving foreign persons*—(1) *General rule.* Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if—

(i) The intercompany sale is in the ordinary course of S's trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) *Intercompany sales involving related partnerships.* For purposes of paragraph (d)(1) of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) *Intercompany sales in ordinary course.* For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) *Treatment of a creditor with respect to a loan in nonfunctional currency.* Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if—

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in §1.988–1(a)(2)(i);

(3) The loan is not in a hyperinflationary currency as defined in §1.988–1(f); and

(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) *Receivables.* If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) *Earnings and profits.* A loss or deduction deferred under this section is not reflected in S's earnings and profits before it is taken into account under this section. See, e.g., §§ 1.312–6(a), 1.312–7, and 1.1502–33(c)(2).

(h) *Anti-avoidance rule.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) *Examples.* For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred as to M (rather than as S or B). This section is illustrated by the following examples.

Example 1. Matching and acceleration rules. (a) *Facts.* S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On a separate entity basis, S's loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for $110.

(b) *Matching rule.* Under paragraph (b)(1) of this section, S's sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S's $30 loss is taken into account under the timing principles of the matching rule of § 1.1502–13(c) to reflect the difference for the year between B's corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's $130 basis in the land and would have a $20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire $30 loss into account in Year 3 to reflect the $30 difference in that year between the $10 gain B takes into account and its $20 recomputed loss. The attributes of S's intercompany items and B's corresponding items are determined on a separate entity basis. Thus, S's $30 loss is long-term capital loss and B's $10 gain is ordinary income.

(c) *Acceleration resulting from sale of B stock.* The facts are the same as in paragraph (a) of this *Example 1,* except that on July 1 of Year 3 P sells all of its B stock to X (rather than B's selling the land to X). Under paragraph (c)(1) of this section, S's $30 loss is taken into account under the timing principles of the acceleration rule of § 1.1502–13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its $30 loss into account in Year 3 immediately before B becomes a nonmember. S's loss is long-term capital loss.

(d) *Subgroup principles applicable to sale of S and B stock.* The facts are the same as in paragraph (a) of this *Example 1,* except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B's selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P's sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S's loss is not taken into account as a result of P's sale of the stock. Instead, S's loss is taken into account based on subsequent events (e.g., B's sale of the land to a nonmember).

Example 2. Distribution of loss property. (a) *Facts.* S holds land with a basis of $130 and value of $100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for $110.

(b) *No loss taken into account.* Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, § 1.1502–13(f)(2)(iii) does not apply to cause S to recognize a $30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group, § 1.1502–13(f)(2)(iii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.)

Example 3. Loss not yet taken into account under separate entity accounting method. (a) *Facts.* S holds land with a basis of $130. On January 1 of Year 1, S sells the land to B at a $30 loss but does not take into account the loss under its separate entity method of accounting until Year 4. On July 1 of Year 3, B sells the land to X for $110.

(b) *Timing.* Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If S and B were members of a consolidated group, S would be treated under §1.1502–13(b)(2)(iii) as taking the loss into account in Year 3.)

Example 4. Consolidated groups. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S holds land for investment with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, P sells 25% of B's stock to X. As a result of P's sale, B becomes a nonmember of the P consolidated group but S and B remain in a controlled group relationship with each other for purposes of section 267(f). Assume that if S and B were divisions of a single corporation, the items of S and B from the land would be ordinary by reason of B's activities.

(b) *Timing and attributes.* Under paragraph (a)(3) of this section, S's sale to B is subject to both §1.1502–13 and this section. Under §1.1502–13, S's loss is redetermined to be an ordinary loss by reason of B's activities. Under paragraph (b)(3) of this section, because S and B remain in a controlled group relationship with each other, the loss is not taken into account under the acceleration rule of §1.1502–13(d) as modified by paragraph (c) of this section. See §1.1502–13(a)(4). Nevertheless, S's loss is redetermined by §1.1502–13 to be an ordinary loss, and the character of the loss is not further redetermined under this section. Thus, the loss continues to be deferred under this section, and will be taken into account as ordinary loss based on subsequent events (e.g., B's sale of the land to a nonmember).

(c) *Resale to controlled group member.* The facts are the same as in paragraph (a) of this *Example 4*, except that P owns 75% of X's stock, and B resells the land to X (rather than P's selling any B stock). The results for S's loss are the same as in paragraph (b) of this *Example 4*. Under paragraph (b) of this section, X is also in a controlled group relationship, and B's sale to X is a second intercompany sale. Thus, S's loss continues to be deferred and is taken into account under this section as ordinary loss based on subsequent events (e.g., X's sale of the land to a nonmember).

Example 5. Intercompany sale followed by installment sale. (a) *Facts.* S holds land for investment with a basis of $130x. On January 1 of Year 1, S sells the land to B for $100x. B holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's $110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of $55x in Year 4 and $55x in Year 5. Section 453A applies to X's note.

(b) *Timing and attributes.* Under paragraph (c) of this section, S's $30x loss is taken into account under the timing principles of the matching rule of §1.1502–13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account $5x of gain in Year 4 and in Year 5. Therefore, S takes $20x of its loss into account in Year 3 to reflect the $20x difference in that year between B's $0 loss taken into account and its $20x recomputed loss. In addition, S takes $5x of its loss into account in Year 4 and in Year 5 to reflect the $5x difference in each year between B's $5x gain taken into account and its $0 recomputed gain. Although S takes into account a loss and B takes into account a gain, the attributes of B's $10x gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's $10x gain on the installment sale beginning in Year 3.

Example 6. Section 721 transfer to a related nonmember. (a) *Facts.* S owns land with a basis of $130. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) *Timing.* Under paragraph (c)(1)(iii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 707(b), S's $30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and S's sale to B were also subject to §1.1502–13.)

Example 7. Receivables. (a) *Controlled group.* S owns goods with a $60 basis. In Year 1, S sells the goods to X for X's $100 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for payment of principal in Year 5. S takes into account $40 of income in Year 1 under its method of accounting. In Year 2, the fair market value of X's note falls to $90 due to an increase in prevailing market interest rates, and S sells the note to B for its $90 fair market value.

(b) *Loss not deferred.* Under paragraph (f) of this section, S takes its $10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's $10 loss would be taken into account in Year 2.)

(c) *Consolidated group.* Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells to X goods having a basis of $90 for X's $100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account $10 of income in Year 1. In Year 2, S sells the receivable to B for its $85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that $10 of S's loss (i.e., the extent to which S's $15 loss does not exceed its $10 of income) is not deferred under this section, S's entire $15 loss is subject to §1.1502–13 and none of the loss is taken into account in Year 2 under the matching rule of §1.1502–13(c). See paragraph (a)(3) of this section (continued deferral under §1.1502–13). P's sale of B stock results in B becoming a nonmember of the P consolidated group in Year 3. Thus, S's $15 loss is taken into account in Year 3 under the acceleration rule of §1.1502–13(d). Nevertheless, B remains in a controlled group relationship with S and paragraph (f) of this section permits only $10 of S's loss to be taken into account in Year 3. See §1.1502–13(a)(4) (continued deferral under section 267). The remaining $5 of S's loss continues to be deferred under this section and taken into account under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember).

Example 8. Selling member ceases to be a member. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a basis of $130 and value of $100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for $100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's $30 loss into account. P has no plan or intention to dispose of the X stock.

(b) *Timing.* Under paragraph (c) of this section, S's $30 loss ordinarily is taken into account immediately before P's transfer of the S stock, under the timing principles of the acceleration rule of §1.1502–13(d). Although taking S's loss into account results in a $30 negative stock basis adjustment under §1.1502–32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by $30 under §§1.1502–32 and 1.1502–33 immediately before P's transfer of the S stock.

(c) Nonhistoric assets. Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the controlled group, P forms M with a $100 contribution on January 1 of Year 1 and S sells the land to M for $100. On December 1 of Year 1, when the value of the land has decreased to $90, M sells the land to B for $90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's $10 loss ordinarily is taken into account under the timing principles of the acceleration rule of §1.1502–13(d) immediately before M becomes a nonmember. (S's $30 loss is not taken into account under the timing principles of §1.1502–13(c) or §1.1502–13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under §1.1502–32, the negative adjustment only eliminates the $10 duplicate stock loss. Under paragraph (h) of this section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by $10 under §§1.1502–32 and 1.1502–33 immediately before P's sale of the M stock.

Example 9. Sale of stock by consolidated group member to controlled group member. (a) *Facts.* P1, a domestic corporation, owns 75% of the outstanding stock of P, the common parent of a consolidated group. P owns all of the outstanding stock of subsidiaries M and S, which are members of P's consolidated group. M and S each own 50% of the only class of stock of L, a nonmember life insurance company. On January 1 of Year 1, S sells 25% of L's stock to P1 for $50 cash. At the time of the sale, S's aggregate basis in the L shares transferred to P1 was $80, and S recognizes a $30 loss. On February 18 of Year 3, at a time when the L shares held by P1 are worth $60, L liquidates. As a result of the liquidation, P1 recognizes a $10 gain.

(b) *Timing.* Under paragraph (a)(2) of this section, S's loss on the sale of the L stock to P1 is deferred. Under paragraph (c)(1)(iv) of this section, upon the liquidation of L, to the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13, S's loss continues to be deferred. Under the principles of §1.1502–13, S's loss is not redetermined to be a noncapital, nondeductible amount to the extent of P1's $10 of gain recognized. Accordingly, S takes into account $10 of loss as a result of the liquidation. In determining whether the remainder of S's $20 loss would be redetermined to be a noncapital, nondeductible amount, under paragraph (c)(1)(iv) of this section, stock held by P1, stock held by M, and stock held by S is taken into account. Accordingly, under the principles of §1.1502–13, the liquidation of L would be treated as a liquidation qualifying under section 332, and the remainder of S's loss would be redetermined to be a noncapital, nondeductible amount. Thus, under paragraph (c)(1)(iv), S's remaining $20 loss continues to be deferred until S and P1 are no longer in a controlled group relationship.

Example 10. Issuance of stock to controlled group member. (a) *Facts.* FP is a foreign corporation that owns all the stock of FS, a foreign corporation, and all the stock of P, a domestic corporation. P owns all of the single class of outstanding common stock of T. In Year 1, FS contributes cash to T in exchange for newly issued stock of T that constitutes 40 percent of T's outstanding stock. In Year 2, when the value of the T stock owned by P is less than its basis in P's hands, P sells all of its T stock to FP. In Year 3, in a transaction unrelated to the issuance of the T stock in Year 1, T converts under state law to a limited liability company that is treated as a partnership for Federal income tax purposes.

(b) *Timing.* Under paragraph (a)(2) of this section, P's loss on the sale of its T stock is deferred. Under paragraph (c)(1)(iv) of this section, upon the conversion of T, to the extent P's loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502–13, P's loss continues to be deferred. In determining whether the loss would be redetermined to be a noncapital, nondeductible amount, stock held by FS (which was acquired from T) and stock held by FP (the buyer of the T stock from P and a member of P's controlled group) is taken into account. Accordingly, under the principles of §1.1502–13 the deemed liquidation of T resulting from the conversion of T would be treated as a liquidation qualifying under section 332, and P's loss would be redetermined to be a noncapital, nondeductible amount. Thus, under paragraph (c)(1)(iv), P's loss continues to be deferred until P and FP are no longer in a controlled group relationship.

(k) *Cross-reference.* For additional rules applicable to the disposition, deconsolidation, or transfer of the stock of members of consolidated groups, see §§1.337(d)–2, 1.1502–13(f)(6), 1.1502–35, and 1.1502–36.

(l) *Effective dates*—(1) *In general.* This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are treated inconsistently, prior law (and not this section) applies to the transaction.

(2) *Avoidance transactions.* This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section.

(3) *Effective/applicability date.* Paragraph (c)(1)(iv) of this section applies to a loss that continues to be deferred pursuant to that paragraph if the event that would cause the loss to be redetermined as a noncapital nondeductible amount under the principles of §1.1502–13 occurs on or after April 16, 2012.

(4) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995 see the applicable regulations issued under sections 267 and 1502. See, e.g., §§1.267(f)–1, 1.267(f)–1T, 1.267(f)–2T, 1.267(f)–3, 1.1502–13, 1.1502–13T, 1.1502–14, 1.1502–14T, and 1.1502–31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

[T.D. 8597, 60 FR 36680, July 18, 1995, as amended by T.D. 8660, 61 FR 10499, Mar. 14, 1996; 62 FR 12097, Mar. 14, 1997; T.D. 9048, 68 FR 12290, Mar. 14, 2003; T.D. 9187, 70 FR 10327, Mar. 3, 2005; T.D. 9254, 71 FR 13018, Mar. 14, 2006; T.D. 9424, 73 FR 53986, Sept. 17, 2008; T.D. 9583, 77 FR 22482, Apr. 16, 2012]

§ 1.268–1 Items attributable to an unharvested crop sold with the land.

In computing taxable income no deduction shall be allowed in respect of items attributable to the production of an unharvested crop which is sold, exchanged, or involuntarily converted with the land and which is considered as property used in the trade or business under section 1231(b)(4). Such items shall be so treated whether or not the taxable year involved is that of the sale, exchange, or conversion of such crop and whether they are for expenses, depreciation, or otherwise. If the taxable year involved is not that of the sale, exchange, or conversion of such crop, a recomputation of the tax liability for such year shall be made; such recomputation should be in the form of an ''amended return'' if necessary. For the adjustments to basis as a result of such disallowance, see section 1016(a)(11) and the regulations thereunder.

§ 1.269–1 Meaning and use of terms.

As used in section 269 and §§ 1.269–2 through 1.269–7:

(a) *Allowance.* The term *allowance* refers to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among other things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(b) *Evasion or avoidance.* The phrase *evasion or avoidance* is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) *Control.* The term *control* means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. For control to be ''acquired on or after October 8, 1940'', it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation on October 8, 1940, as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.

(d) *Person.* The term *person* includes an individual, a trust, an estate, a partnership, an association, a company or a corporation.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 345, Jan. 6, 1992]

§ 1.269–2 Purpose and scope of section 269.

(a) *General.* Section 269 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income tax. See § 1.269–3.

(b) *Disallowance of deduction, credit, or other allowance.* Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character, or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are Gregory v. Helvering (1935) (293 U.S. 465; Ct. D. 911, C.B. XIV–1, 193); Griffiths v. Helvering (1939) (308 U.S. 355; Ct. D. 1431, C.B. 1940–1, 136); Higgins v. Smith (1940) (308 U.S. 473; Ct. D. 1434, C.B. 1940–1, 127); and J. D. & A. B. Spreckles Co. v. Commissioner (1940) (41 B.T.A. 370). In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 267 and section 270, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 269 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately. See, for example, § 1.269–6.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962]

§ 1.269–3 Instances in which section 269(a) disallows a deduction, credit, or other allowance.

(a) *Instances of disallowance.* Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which:

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) Any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions fall within the provisions of section 269 which would not have been made if the evasion or avoidance purpose was not present. The determination of the purpose for which an acquisition was made requires a scrutiny of the entire circumstances in which the transaction or course of conduct occurred, in connection with the tax result claimed to arise therefrom.

(b) *Acquisition of control; transactions indicative of purpose to evade or avoid tax.* If the requisite acquisition of control within the meaning of paragraph (1) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring control was evasion or avoidance of Federal income tax:

(1) A corporation or other business enterprise (or the interest controlling such corporation or enterprise) with large profits acquires control of a corporation with current, past, or prospective credits, deductions, net operating losses, or other allowances and the acquisition is followed by such transfers or other action as is necessary to bring the deduction, credit, or other allowance into conjunction with the income (see further § 1.269–6). This subparagraph may be illustrated by the following example:

Example. Individual A acquires all of the stock of L Corporation which has been engaged in the business of operating retail drug stores. At the time of the acquisition, L Corporation has net operating loss carryovers aggregating $100,000 and its net worth is $100,000. After the acquisition, L Corporation continues to engage in the business of operating retail drug stores but the profits attributable to such business after the acquisition are not sufficient to absorb any substantial portion of the net operating loss carryovers. Shortly after the acquisition, individual A causes to be transferred to L Corporation the assets of a hardware business previously controlled by A which business produces profits sufficient to absorb a substantial portion of L Corporation's net operating loss carryovers. The transfer of the profitable business, which has the effect of using net operating loss carryovers to offset gains of a business unrelated to that which produced the losses, indicates that the principal purpose for which the acquisition of control was made is evasion or avoidance of Federal income tax.

(2) A person or persons organize two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions (see section 11(c)) or multiple minimum accumulated earnings credits (see section 535(c)(2) and (3)).

(3) A person or persons with high earning assets transfer them to a newly organized controlled corporation retaining assets producing net operating losses which are utilized in an attempt to secure refunds.

(c) *Acquisition of property; transactions indicative of purpose to evade or avoid tax.* If the requisite acquisition of property within the meaning of paragraph (2) of section 269(a) exists, the transactions set forth in the following subparagraphs are among those which, in the absence of additional evidence to the contrary, ordinarily are indicative that the principal purpose for acquiring such property was evasion or avoidance of Federal income tax:

(1) A corporation acquires property having in its hands an aggregate carryover basis which is materially greater than its aggregate fair market value at the time of such acquisition and utilizes the property to create tax-reducing losses or deductions.

(2) A subsidiary corporation, which has sustained large net operating losses in the operation of business X and which has filed separate returns for the taxable years in which the losses were sustained, acquires high earning assets, comprising business Y, from its parent corporation. The acquisition occurs at a time when the parent would not succeed to the net operating loss carryovers of the subsidiary if the subsidiary were liquidated, and the profits of business Y are sufficient to offset a substantial portion of the net operating loss carryovers attributable to business X (see further *Example 3* of §1.269–6).

(d) *Ownership changes to which section 382(l)(5) applies; transactions indicative of purpose to evade or avoid tax*—(1) *In general.* Absent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case (as defined in section 382(l)(5)(G)). The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is made without regard to the continuity of business enterprise set forth in §1.368–1(d). The determination is based on all the facts and circumstances, including, for example, the amount of business assets that continue to be used, or the number of employees in the work force who continue employment, in an active trade or business (although not necessarily the historic trade or business). Where the corporation continues to utilize a significant amount of its business assets or work force, the requirement of carrying on more than an insignificant amount of an active trade or business may be met even though all trade or business activities temporarily cease for a period of time in order to address business exigencies.

(2) *Effective date.* The presumption under paragraph (d) of this section applies to acquisitions of control or property effected pursuant to a plan of reorganization confirmed by a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)) after August 14, 1990.

(e) *Relationship of section 269 to 11 U.S.C. 1129(d).* In determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization in a case under title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. 1129(d) is not taken into account and any determination by a court under 11 U.S.C. 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.

[T.D. 6595, 27 FR 3596, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 345, Jan. 6, 1992]

§ 1.269–4 Power of district director to allocate deduction, credit, or allowance in part.

The district director is authorized by section 269(b) to allow a part of the amount disallowed by section 269(a), but he may allow such part only if and to the extent that he determines that the amount allowed will not result in the evasion or avoidance of Federal income tax for which the acquisition was made. The district director is also authorized to use other methods to give effect to part of the amount disallowed under section 269(a), but only to such extent as he determines will not result in the evasion or avoidance of Federal income tax for which the acquisition was made. Whenever appropriate to give proper effect to the deduction, credit, or other allowance, or such part of it which may be allowed, this authority includes the distribution, apportionment, or allocation of both the gross income and the deductions, credits, or other allowances the benefit of which was sought, between or among the corporations, or properties, or parts thereof, involved, and includes the disallowance of any such deduction, credit, or other allowance to any of the taxpayers involved.

[T.D. 6595, 27 FR 3597, Apr. 14, 1962]

§ 1.269–5 Time of acquisition of control.

(a) *In general.* For purposes of section 269, an acquisition of control occurs when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of share of all classes of stock of the corporation.

(b) *Application of general rule to certain creditor acquisitions.* (1) For purposes of section 269, creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) acquire control of the corporation when they acquire beneficial ownership of the requisite amount of stock. Although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock. Solely for purposes of section 269, creditors of a bankrupt corporation are treated as acquiring beneficial ownership of stock of the corporation no earlier than the time a bankruptcy court confirms a plan of reorganization.

(2) The provisions of this section are illustrated by the following example.

Example. Corporation *L* files a petition under chapter 11 of the Bankruptcy Code on January 5, 1987. A creditors' committee is formed. On February 22, 1987, and upon the request of the creditors, the bankruptcy court removes the debtor-in-possession from business management and operations and appoints a trustee. The trustee consults regularly with the creditors' committee in formulating both short-term and long-term management decisions. After three years, the creditors approve a plan of reorganization in which the outstanding stock of Corporation *L* is canceled and its creditors receive shares of stock constituting all of the outstanding shares. The bankruptcy court confirms the plan of reorganization on March 23, 1990, and the plan is put into effect on May 25, 1990. For purposes of section 269, the creditors acquired control of Corporation *L* than March 23, 1990. Similarly, the determination of whether the creditors acquired control of Corporation *L* no earlier with the principal purpose of evasion or avoidance of Federal income tax is made by reference to the creditors' purposes as of no earlier than March 23, 1990.

[T.D. 8388, 57 FR 346, Jan. 6, 1992]

§ 1.269–6 Relationship of section 269 to section 382 before the Tax Reform Act of 1986.

Section 269 and §§ 1.269–1 through 1.269–5 may be applied to disallow a net operating loss carryover even though such carryover is not disallowed (in whole or in part) under section 382 and the regulations thereunder. This section may be illustrated by the following examples:

Example 1. L Corporation has computed its taxable income on a calendar year basis and has sustained heavy net operating losses for a number of years. Assume that A purchases all of the stock of L Corporation on December 31, 1955, for the principal purpose of utilizing its net operating loss carryovers by changing its business to a profitable new business. Assume further that A makes no attempt to revitalize the business of L Corporation during the calendar year 1956 and that during January 1957 the business is changed to an entirely new and profitable business. The carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

Example 2. L Corporation has sustained heavy net operating losses for a number of years. In a merger under State law, P Corporation acquires all of the assets of L Corporation for the principal purpose of utilizing the net operating loss carryovers of L Corporation against the profits of P Corporation's business. As a result of the merger, the former stockholders of L Corporation own, immediately after the merger, 12 percent of the fair market value of the outstanding stock of P Corporation. If the merger qualifies as a reorganization to which section 381(a) applies, the entire net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

Example 3. L Corporation has been sustaining net operating losses for a number of years. P Corporation, a profitable corporation, on December 31, 1955, acquires all the stock of L Corporation for the purpose of continuing and improving the operation of L Corporation's business. Under the provisions of sections 334(b)(2) and 381(a)(1), P Corporation would not succeed to L Corporation's net operating loss carryovers if L Corporation were liquidated pursuant to a plan of liquidation adopted within two years after the date of the acquisition. During 1956, P Corporation transfers a profitable business to L Corporation for the principal purpose of using the profits of such business to absorb the net operating loss carryovers of L Corporation. The transfer is such as to cause the basis of the transferred assets in the hands of L Corporation to be determined by reference to their basis in the hands of P Corporation. L Corporation's net operating loss carryovers will be disallowed under the provisions of section 269(a) without regard to the application of section 382.

[T.D. 6595, 27 FR 3597, Apr. 14, 1962, as amended by T.D. 8388, 57 FR 346, Jan. 6, 1992]

§ 1.269–7 Relationship of section 269 to sections 382 and 383 after the Tax Reform Act of 1986.

Section 269 and §§ 1.269–1 through 1.269–5 may be applied to disallow a deduction, credit, or other allowance notwithstanding that the utilization or amount of a deduction, credit, or other allowance is limited or reduced under section 382 or 383 and the regulations thereunder. However, the fact that the amount of taxable income or tax that may be offset by a deduction, credit, or other allowance is limited under section 382(a) or 383 and the regulations thereunder is relevant to the determination of whether the principal purpose of an acquisition is the evasion or avoidance of Federal income tax.

[T.D. 8388, 57 FR 346, Jan. 6, 1992]

§ 1.269B–1 Stapled foreign corporations.

(a) *Treatment as a domestic corporation*—(1) *General rule.* Except as otherwise provided, if a foreign corporation is a stapled foreign corporation within the meaning of paragraph (b)(1) of this section, such foreign corporation will be treated as a domestic corporation for U.S. Federal income tax purposes. Accordingly, for example, the worldwide income of such corporation will be subject to the tax imposed by section 11. For application of the branch profits tax under section 884, and application of sections 871(a), 881, 1441, and 1442 to dividends and interest paid by a stapled foreign corporation, see §§ 1.884–1(h) and 1.884–4(d).

(2) *Foreign owned exception.* Paragraph (a)(1) of this section will not apply if a foreign corporation and a domestic corporation are stapled entities (as provided in paragraph (b) of this section) and such foreign and domestic corporations are foreign owned within the meaning of this paragraph (a)(2). A corporation will be treated as foreign owned if it is established to the satisfaction of the Commissioner that United States persons hold directly (or indirectly applying section 958(a)(2) and (3) and section 318(a)(4)) less than 50 percent of the total combined voting power of all classes of stock entitled to vote and less than 50 percent of the total value of the stock of such corporation. For the consequences of a stapled foreign corporation becoming or ceasing to be foreign owned, therefore converting its status as either a foreign or domestic corporation within the meaning of this paragraph (a)(2), see paragraph (c) of this section.

(b) *Definition of a stapled foreign corporation*—(1) *General rule.* A foreign corporation is a stapled foreign corporation if such foreign corporation and a domestic corporation are stapled entities. A foreign corporation and a domestic corporation are stapled entities if more than 50 percent of the aggregate value of each corporation's beneficial ownership consists of interests that are stapled. In the case of corporations with more than one class of stock, it is not necessary for a class of stock representing more than 50 percent of the beneficial ownership of the foreign corporation to be stapled to a class of stock representing more than 50 percent of the beneficial ownership of the domestic corporation, provided that more than 50 percent of the aggregate value of each corporation's beneficial ownership (taking into account all classes of stock) are in fact stapled. Interests are stapled if a transferor of one or more interests in one entity is required, by form of ownership, restrictions on transfer, or other terms or conditions, to transfer interests in the other entity. The determination of whether interests are stapled for this purpose is based on the relevant facts and circumstances, including, but not limited to, the corporations' by-laws, articles of incorporation or association, and stock certificates, shareholder agreements, agreements between the corporations, and voting trusts with respect to the corporations. For the consequences of a foreign corporation becoming or ceasing to be a stapled foreign corporation (*e.g.*, a corporation that is no longer foreign owned) under this paragraph (b)(1), see paragraph (c) of this section.

(2) *Related party ownership rule.* For purposes of determining whether a foreign corporation is a stapled foreign corporation, the Commissioner may, at his discretion, treat interests that otherwise would be stapled interests as not being stapled if the same person or related persons (within the meaning of section 267(b) or 707(b)) hold stapled interests constituting more than 50 percent of the beneficial ownership of both corporations, and a principal purpose of the stapling of those interests is the avoidance of U.S. income tax. A stapling of interests may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(3) *Example.* The principles of paragraph (b)(1) of this section are illustrated by the following example:

Example. USCo, a domestic corporation, and FCo, a foreign corporation, are publicly traded companies, each having two classes of stock outstanding. USCo's class A shares, which constitute 75% of the value of all beneficial ownership in USCo, are stapled to FCo's class B shares, which constitute 25% of the value of all beneficial ownership in F Co. USCo's class B shares, which constitute 25% of the value of all beneficial ownership in USCo, are stapled to FCo class A shares, which constitute 75% of the value of all beneficial ownership in FCo. Because more than 50% of the aggregate value of the stock of each corporation is stapled to the stock of the other corporation, USCo and FCo are stapled entities within the meaning of section 269B(c)(2).

(c) *Changes in domestic or foreign status.* The deemed conversion of a foreign corporation to a domestic corporation under section 269B is treated as a reorganization under section 368(a)(1)(F). Similarly, the deemed conversion of a corporation that is treated as a domestic corporation under section 269B to a foreign corporation is treated as a reorganization under section 368(a)(1)(F). For the consequences of a deemed conversion, including the closing of a corporation's taxable year, see §§ 1.367(a)–1(e), (f) and 1.367(b)–2(f).

(d) *Includible corporation*—(1) Except as provided in paragraph (d)(2) of this section, a stapled foreign corporation treated as a domestic corporation under section 269B nonetheless is treated as a foreign corporation in determining whether it is an includible corporation within the meaning of section 1504(b). Thus, for example, a stapled foreign corporation is not eligible to join in the filing of a consolidated return under section 1501, and a dividend paid by such corporation is not a qualifying dividend under section 243(b), unless a valid section 1504(d) election is made with respect to such corporation.

(2) A stapled foreign corporation is treated as a domestic corporation in determining whether it is an includible corporation under section 1504(b) for purposes of applying §§ 1.904(i)–1 and 1.861–11T(d)(6).

(e) *U.S. treaties*—(1) A stapled foreign corporation that is treated as a domestic corporation under section 269B may not claim an exemption from U.S. income tax or a reduction in U.S. tax rates by reason of any treaty entered into by the United States.

(2) The principles of this paragraph (e) are illustrated by the following example:

Example. FCo, a Country X corporation, is a stapled foreign corporation that is treated as a domestic corporation under section 269B. FCo qualifies as a resident of Country X pursuant to the income tax treaty between the United States and Country X. Under such treaty, the United States is permitted to tax business profits of a Country X resident only to the extent that the business profits are attributable to a permanent establishment of the Country X resident in the United States. While FCo earns income from sources within and without the United States, it does not have a permanent establishment in the United States within the meaning of the relevant treaty. Under paragraph (e)(1) of this section, however, FCo is subject to U.S. Federal income tax on its income as a domestic corporation without regard to the provisions of the U.S.-Country X treaty and therefore without regard to the fact that FCo has no permanent establishment in the United States.

(f) *Tax assessment and collection procedures*—(1) *In general.* (i) Any income tax imposed on a stapled foreign corporation by reason of its treatment as a domestic corporation under section 269B (whether such income tax is shown on the stapled foreign corporation's U.S. Federal income tax return or determined as a deficiency in income tax) shall be assessed as the income tax liability of such stapled foreign corporation.

(ii) Any income tax assessed as a liability of a stapled foreign corporation under paragraph (f)(1)(i) of this section shall be considered as having been properly assessed as an income tax liability of the stapled domestic corporation (as defined in paragraph (f)(4)(i) of this section) and all 10-percent shareholders of the stapled foreign corporation (as defined in paragraph (f)(4)(ii) of this section). The date of such deemed assessment shall be the date the income tax liability of the stapled foreign corporation was properly assessed. The Commissioner may collect such income tax from the stapled domestic corporation under the circumstances set forth in paragraph (f)(2) of this section and may collect such income tax from any 10-percent shareholders of the stapled foreign corporation under the circumstances set forth in paragraph (f)(3) of this section.

(2) *Collection from domestic stapled corporation.* If the stapled foreign corporation does not pay its income tax liability that was properly assessed, the unpaid balance of such income tax or any portion thereof may be collected from the stapled domestic corporation, provided that the following conditions are satisfied—

(i) The Commissioner has issued a notice and demand for payment of such income tax to the stapled foreign corporation in accordance with §301.6303–1 of this Chapter;

(ii) The stapled foreign corporation has failed to pay the income tax by the date specified in such notice and demand;

(iii) The Commissioner has issued a notice and demand for payment of the unpaid portion of such income tax to the stapled domestic corporation in accordance with §301.6303–1 of this Chapter.

(3) *Collection from 10-percent shareholders of the stapled foreign corporation.* The unpaid balance of the stapled foreign corporation's income tax liability may be collected from a 10-percent shareholder of the stapled foreign corporation, limited to each such shareholder's income tax liability as determined under paragraph (f)(4)(iv) of this section, provided the following conditions are satisfied—

(i) The Commissioner has issued a notice and demand to the stapled domestic corporation for the unpaid portion of the stapled foreign corporation's income tax liability, as provided in paragraph (f)(2)(iii) of this section;

(ii) The stapled domestic corporation has failed to pay the income tax by the date specified in such notice and demand;

(iii) The Commissioner has issued a notice and demand for payment of the unpaid portion of such income tax to such 10-percent shareholder of the stapled foreign corporation in accordance with §301.6303–1 of this Chapter.

(4) *Special rules and definitions.* For purposes of this paragraph (f), the following rules and definitions apply:

(i) *Stapled domestic corporation.* A domestic corporation is a *stapled domestic corporation* with respect to a stapled foreign corporation if such domestic corporation and the stapled foreign corporation are stapled entities as described in paragraph (b)(1) of this section.

(ii) *10-percent shareholder.* A *10-percent shareholder* of a stapled foreign corporation is any person that owned directly 10 percent or more of the total value or total combined voting power of all classes of stock in the stapled foreign corporation for any day of the stapled foreign corporation's taxable year with respect to which the income tax liability relates.

(iii) *10-percent shareholder in the case of indirect ownership of stapled foreign corporation stock.* [Reserved]

(iv) *Determination of a 10-percent shareholder's income tax liability.* The income tax liability of a 10-percent shareholder of a stapled foreign corporation, for the income tax of the stapled foreign corporation under section 269B and this section, is determined by assigning an equal portion of the total income tax liability of the stapled foreign corporation for the taxable year to each day in such corporation's taxable year, and then dividing that portion ratably among the shares outstanding for that day on the basis of the relative values of such shares. The liability of any 10-percent shareholder for this purpose is the sum of the income tax liability allocated to the shares held by such shareholder for each day in the taxable year.

(v) *Income tax.* The term *income tax* means any income tax liability imposed on a domestic corporation under title 26 of the United States Code, including additions to tax, additional amounts, penalties, and interest related to such income tax liability.

(g) *Effective dates*—(1) Except as provided in this paragraph (g), the provisions of this section are applicable for taxable years that begin after July 29, 2005.

(2) Paragraphs (d)(1) and (f) of this section (except as applied to the collection of tax from any 10-percent shareholder of a stapled foreign corporation that is a foreign person) are applicable beginning on—

(i) July 18, 1984, for any foreign corporation that became stapled to a domestic corporation after June 30, 1983; and

(ii) January 1, 1987, for any foreign corporation that was stapled to a domestic corporation as of June 30, 1983.

(3) Paragraph (d)(2) of this section is applicable for taxable years beginning after July 22, 2003, except that in the case of a foreign corporation that becomes stapled to a domestic corporation on or after July 22, 2003, paragraph (d)(2) of this section applies for taxable years ending on or after July 22, 2003.

(4) Paragraph (e) of this section is applicable beginning on July 18, 1984, except as provided in paragraph (g)(5) of this section.

(5) In the case of a foreign corporation that was stapled to a domestic corporation as of June 30, 1983, which was entitled to claim benefits under an income tax treaty as of that date, and which remains eligible for such treaty benefits, paragraph (e) of this section will not apply to such foreign corporation and for all purposes of the Internal Revenue Code such corporation will continue to be treated as a foreign entity. The prior sentence will continue to apply even if such treaty is subsequently modified by protocol, or superseded by a new treaty, so long as the stapled foreign corporation continues to be eligible to claim such treaty benefits. If the treaty benefits to which the stapled foreign corporation was entitled as of June 30, 1983, are terminated, then a deemed conversion of the foreign corporation to a domestic corporation shall occur pursuant to paragraph (c) of this section as of the date of such termination.

[T.D. 9216, 70 FR 43758, July 29, 2005, as amended by T.D. 9739, 80 FR 56912, Sept. 21, 2015]

§ 1.270–1 Limitation on deductions allowable to individuals in certain cases.

(a) *Recomputation of taxable income.* (1) Under certain circumstances, section 270 limits the deductions (other than certain deductions described in subsection (b) thereof) attributable to a trade or business carried on by an individual which are otherwise allowable to such individual under the provisions of chapter 1 of the Code or the corresponding provisions of prior revenue laws. If, in each of five consecutive taxable years (including at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954), the deductions attributable to a trade or business carried on by an individual (other than the specially treated deductions described in paragraph (b) of this section) exceed the gross income derived from such trade or business by more than $50,000, the taxable income computed under section 63 (or the net income computed under the corresponding provisions of prior revenue laws) of such individual shall be recomputed for each of such taxable years.

(2) In recomputing the taxable income (or the net income, in the case of taxable years which are otherwise subject to the Internal Revenue Code of 1939) for each of the five taxable years, the deductions (other than the specially treated deductions described in paragraph (b) of this section with the exception of the net operating loss deduction) attributable to the trade or business carried on by the individual shall be allowed only to the extent of (i) the gross income derived from such trade or business, plus (ii) $50,000. The specially treated deductions described in paragraph (b) of this section (other than the net operating loss deduction) shall each be allowed in full. The net operating loss deduction, to the extent attributable to such trade or business, shall be disallowed in its entirety. Thus, a carryover or a carryback of a net operating loss so attributable, either from a year within the period of five consecutive taxable years or from a taxable year outside of such period, shall be ignored in making the recomputation of taxable income or net income, as the case may be.

(3) The limitations on deductions provided by section 270 are also applicable in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover or carryback from any year which falls within the provisions of section 270 to any year which does not fall within such provisions. Also, in determining under section 172, or the corresponding provisions of prior revenue laws, the amount of any net operating loss carryover from a year which falls within the provisions of section 270 to a year which does not fall within such provisions, the amount of net operating loss is to be reduced by the taxable income or net income, as the case may be (computed as provided in § 1.172–5, or 26 CFR (1939) 39.122–4(c) (Regulations 118), as the case may be and, in the case of any taxable year which falls within the provisions of section 270, determined after the application of section 270), of any taxable year preceding or succeeding the taxable year of the net operating loss to which such loss must first be carried back or carried over under the provisions of section 172(b), or the corresponding provisions of prior revenue laws, even though the net operating loss deduction is not an allowable deduction for such preceding or succeeding taxable year.

(4) If an individual carries on several trades or businesses, the deductions attributable to such trades or businesses and the gross income derived therefrom shall not be aggregated in determining whether the deductions (other than the specially treated deductions) exceed the gross income derived from such trades or businesses by more than $50,000 in any taxable year. For the purposes of section 270, each trade or business shall be considered separately. However, where a particular business of an individual is conducted in one or more forms such as a partnership, joint venture, or individual proprietorship, the individual's share of the profits and losses from each business unit must be aggregated to determine the applicability of section 270. See paragraphs (a)(8)(ii) and (b) of § 1.702–1, relating to applicability of section 270 to a partner. Where it is established that for tax purposes a husband and wife are partners in the same trade or business or that each is participating independently of the other in the same trade or business with his and her own money, the husband's gross income and deductions from that trade or business shall be considered separately from the wife's gross income and deductions from that trade or business even though they file a joint return. Where a taxpayer is engaged in a trade or business in a community property State under circumstances such that the income therefrom is considered to

be community income, the taxpayer and his spouse are treated for purposes of section 270 as two individuals engaged separately in the same trade or business and the gross income and deductions attributable to the trade or business are allocated one-half to the taxpayer and one-half to the spouse. Where several business activities emanate from a single commodity, such as oil or gas or a tract of land, it does not necessarily follow that such activities are one business for the purposes of section 270. However, in order to be treated separately, it must be established that such business activities are actually conducted separately and are not closely interrelated with each other. For the purposes of section 270, the trade or business carried on by an individual must be the same in each of the five consecutive years in which the deductions (other than the specially treated deductions) exceed the gross income derived from such trade or business by more than $50,000.

(5) For the purposes of section 270, a taxable year may be part of two or more periods of five consecutive taxable years. Thus, if the deductions (other than the specially treated deductions) attributable to a trade or business carried on by an individual exceed the gross income therefrom by more than $50,000 for each of six consecutive taxable years, the fifth year of such six consecutive taxable years shall be considered to be a part both of a five-year period beginning with the first and ending with the fifth taxable year and of a five-year period beginning with the second and ending with the sixth taxable year.

(6) For the purposes of section 270, a short taxable year required to effect a change in accounting period constitutes a taxable year. In determining the applicability of section 270 in the case of a short taxable year, items of income and deduction are not annualized.

(b) *Specially treated deductions.* (1) For the purposes of section 270 and paragraph (a) of this section, the specially treated deductions are:

(i) Taxes,

(ii) Interest,

(iii) Casualty and abandonment losses connected with a trade or business deductible under section 165(c)(1) or the corresponding provisions of prior revenue laws,

(iv) Losses and expenses of the trade or business of farming which are directly attributable to drought,

(v) The net operating loss deduction allowed by section 172, or the corresponding provisions of prior revenue laws, and

(vi) Expenditures as to which a taxpayer is given the option, under law or regulations, either (*a*) to deduct as expenses when incurred, or (*b*) to defer or capitalize.

(2) For the purpose of subparagraph (1)(iv) of this paragraph, an individual is engaged in the ‘‘trade or business of farming'' if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant. An individual who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the trade or business of farming. However, an individual who receives a fixed rental (without reference to production) is engaged in the trade or business of farming only if he participates to a material extent in the operation or management of the farm. An individual engaged in forestry or the growing of timber is not thereby engaged in the trade or business of farming. An individual cultivating or operating a farm for recreation or pleasure rather than a profit is not engaged in the trade or business of farming. The term *farm* is used in its ordinarily accepted sense and includes stock, dairy, poultry, fruit, crop, and truck farms, and also plantations, ranches, ranges, and orchards. An individual is engaged in the trade or business of farming if he is a member of a partnership engaged in the trade or business of farming.

(3) In order for losses and expenses of the trade or business of farming to qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph such losses and expenses must be directly attributable to drought conditions and not to other causes such as faulty management or unfavorable market conditions. In general, the following are the types of losses and expenses which, if otherwise deductible,

may qualify as specially treated deductions under subparagraph (1)(iv) of this paragraph:

(i) Losses for damages to or destruction of property as a result of drought conditions, if such property is used in the trade or business of farming or is purchased for resale in the trade or business of farming;

(ii) Expenses directly related to raising crops or livestock which are destroyed or damaged by drought. Included in this category are, for example, payments for labor, fertilizer, and feed used in raising such crops or livestock. If such crops or livestock to which the expenditures relate are only partially destroyed or damaged by drought then only a proportionate part of the expenditures is regarded as specially treated deductions; and

(iii) Expenses which would not have been incurred in the absence of drought conditions, such as expenses for procuring pasture or additional supplies of water or feed.

(4) The expenditures referred to in subparagraph (1)(vi) of this paragraph include, but are not limited to, intangible drilling and development costs in the case of oil and gas wells as provided in section 263(c) and the regulations thereunder, and expenditures for the development of a mine or other natural deposit (other than an oil or gas well) as provided in section 616 and the regulations thereunder.

(5) The provisions of section 270(b) do not operate to make an expenditure a deductible item if it is not otherwise deductible under the law applicable to the particular year in which it was incurred. Thus, for example, if it is necessary, pursuant to the provisions of section 270, to recompute the taxable or net income of an individual for the taxable years 1950 through 1954, the individual in making the recomputation may not deduct expenditures paid or incurred in the years 1950 through 1953 which must be capitalized under the law applicable to those years, even though the expenditures are deductible under the Code.

(c) *Applicability to taxable years otherwise subject to the Internal Revenue Code of 1939.* The net income of a taxable year otherwise subject to the Internal Revenue Code of 1939 shall be recomputed pursuant to section 270 if (i) such taxable year is included in a period of five consecutive taxable years which includes at least one taxable year beginning after December 31, 1953, and ending after August 16, 1954, and (ii) the deductions (other than the specially treated deductions specified in section 270(b)) for each taxable year in such five-year period exceed the $50,000 limitation specified in section 270. As described in paragraph (a)(5) of this section, a taxable year may be part of two or more periods of five consecutive taxable years, one meeting the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939 and the other meeting the requirements for recomputation pursuant to section 270 of the Internal Revenue Code of 1954, then the recomputation for such taxable year shall be made pursuant to section 270. For example, if a calendar year taxpayer sustains a loss from a trade or business for each of the years 1949 through 1954, the years 1950, 1951, 1952, and 1953 may be a part of two such periods of five consecutive taxable years. If, however, a taxable year is part of a period of five consecutive taxable years which meets the requirements for recomputation pursuant to section 130 of the Internal Revenue Code of 1939, but is not part of a period which meets the requirements for recomputation, pursuant to section 270, then a recomputation of net income for such taxable year must be made pursuant to section 130.

(d) *Redetermination of tax.* The tax imposed by Chapter 1 of the Code, or by the corresponding provisions of prior revenue laws, for each of the five consecutive taxable years specified in paragraph (a) of this section shall be redetermined upon the basis of the taxable income or net income of the individual, as the case may be, recomputed in the manner described in paragraph (a) of this section. If the assessment of a deficiency is prevented (except for the provisions of Part II (section 1311 and following), Subchapter Q, Chapter 1 of the Code, relating to the effect of limitations and other provisions in income tax cases) by the operation of any provision of law (e.g., sections 6501 and 6502, or the corresponding provisions of prior revenue laws, relating to the period of limitations upon assessment and collection) except section 7122, or the corresponding provisions of prior revenue laws, relating to compromises, or by any rule of law (e.g., res judicata), then the excess of the tax for such year as recomputed over the tax previously determined for such year shall be considered a deficiency for the purposes of section 270. The term *tax previously determined* shall have the same meaning as that assigned to such term by section 1314(a). See §1.1314 (a)–1.

(e) *Assessment of tax.* Any amount determined as a deficiency in the manner described in paragraph (d) of this section in respect of any taxable year of the five consecutive taxable years specified in paragraph (a) of this section may be assessed and collected as if on the date of the expiration of the period of limitation for the assessment of a deficiency for the fifth taxable year of such five consecutive taxable years, one year remained before the expiration of the period of limitation upon assessment for the taxable year in respect of which the deficiency is determined. If the taxable year is one in respect of which an assessment could be made without regard to section 270, the amount of the actual deficiency as defined in section 6211(a) (whether it is greater than, equal to, or less than the deficiency determined under section 270(c)) shall be assessed and collected. However, if the assessment of a deficiency for such taxable year would be prevented by any provision of law (e.g., the period of limitation upon the assessment of tax) except section 7122, or the corresponding provision of prior revenue laws, relating to compromises, or by the operation of any rule of law (e.g., res judicata), then the excess of the tax recomputed as described in paragraph (d) of this section over the tax previously determined may be assessed and collected even though in fact there is no actual deficiency, as defined in section 6211(a), in respect of the given taxable year.

(f) *Effective date; cross reference.* The provisions of section 270 and this section apply to taxable years beginning before January 1, 1970. Thus, for instance, if the taxpayer had a profit of $2,000 attributable to a trade or business in 1965, section 270 and this section would not apply to the taxable years 1966 through 1970, even though he had losses of more than $50,000 in each of the 5 years ending with 1970. For provisions relating to activities not engaged in for profit applicable to taxable years beginning after December 31, 1969, see section 183 and the regulations thereunder.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7198, 37 FR 13685, July 13, 1972]

§ 1.271–1 Debts owed by political parties.

(a) *General rule.* In the case of a taxpayer other than a bank (as defined in section 581 and the regulations thereunder), no deduction shall be allowed under section 166 (relating to bad debts) or section 165(g) (relating to worthlessness of securities) by reason of the worthlessness of any debt, regardless of how it arose, owed by a political party. For example, it is immaterial that the debt may have arisen as a result of services rendered or goods sold or that the taxpayer included the amount of the debt in income. In the case of a bank, no deduction shall be allowed unless, under the facts and circumstances, it appears that the bad debt was incurred to or purchased by, or the worthless security was acquired by, the taxpayer in accordance with its usual commercial practices. Thus, if a bank makes a loan to a political party not in accordance with its usual commercial practices but solely because the president of the bank has been active in the party no bad debt deduction will be allowed with respect to the loan.

(b) *Definitions*—(1) *Political party.* For purposes of this section and §1.276–1, the term *political party* means a political party (as commonly understood), a National, State, or local committee thereof, or any committee, association, or organization, whether incorporated or not, which accepts contributions (as defined in subparagraph (2) of this paragraph) or makes expenditures (as defined in subparagraph (3) of this paragraph) for the purpose of influencing or attempting to influence the election of presidential or vice-presidential electors, or the selection, nomination, or election of any individual to any Federal, State, or local elective public office, whether or not such individual or electors are selected, nominated, or elected. Accordingly, a political party includes a committee or other group which accepts contributions or makes expenditures for the purpose of promoting the nomination of an individual for an elective public office in a primary election, or in any convention, meeting, or caucus of a political party. It is immaterial whether the contributions or expenditures are accepted or made directly or indirectly. Thus, for example, a committee or other group, is considered to be a political party, if, although it does not expend any funds, it turns funds over to another organization, which does expend funds for the purpose of attempting to influence the nomination of an individual for an elective public office. An organization which engages in activities which are truly nonpartisan in nature will not be considered a political party merely because it conducts activities with respect to an election campaign if, under all the facts and circumstances, it is clear that its efforts are not directed to the election of the candidates of any particular party or parties or to the selection, nomination or election of any particular candidate. For example, a committee or group will not be treated as a political party if it is organized merely to inform the electorate as to the identity and experience of all candidates involved, to present on a nonpreferential basis the issues or views of the parties or candidates as described by the parties or candidates, or to provide a forum in which the candidates are freely invited on a nonpreferential basis to discuss or debate the issues.

(2) *Contributions.* For purposes of this section and §1.276–1, the term *contributions* includes a gift, subscription, loan, advance, or deposit, of money or anything of value, and includes a contract, promise, or agreement to make a contribution, whether or not legally enforceable.

(3) *Expenditures.* For purposes of this section and §1.276–1, the term *expenditures* includes a payment, distribution, loan, advance, deposit, or gift, of money or anything of value, and includes a contract, promise, or agreement to make an expenditure, whether or not legally enforceable.

[T.D. 6996, 34 FR 832, Jan. 18, 1969]

§ 1.272–1 Expenditures relating to disposal of coal or domestic iron ore.

(a) *Introduction.* Section 272 provides special treatment for certain expenditures paid or incurred by a taxpayer in connection with a contract (hereafter sometimes referred to as a ''coal royalty contract'' or ''iron ore royalty contract'') for the disposal of coal or iron ore the gain or loss from which is treated under section 631(c) as a section 1231 gain or loss on the sale of coal or iron ore. See paragraph (e) of §1.631–3 for special rules relating to iron ore. The expenditures covered by section 272 are those which are attributable to the making and administering of such a contract or to the preservation of the economic interest retained under the contract. For examples of such expenditures, see paragraph (d) of this section. For a taxable year in which gross royalty income is realized under the contract of disposal, such expenditures shall not be allowed as a deduction. Instead, they are to be added to the adjusted depletion basis of the coal or iron ore disposed of in the taxable year in computing gain or loss under section 631(c). However, where no gross royalty income is realized under the contract of disposal in a particular taxable year, such expenditure shall be treated without regard to section 272.

(b) *In general.* (1) Where the disposal of coal or iron ore is covered by section 631(c), the provisions of section 272 and this section shall be applicable for a taxable year in which there is income under the contract of disposal. (For purposes of section 272 and this section, the term *income* means gross amounts received or accrued which are royalties or bonuses in connection with a contract to which section 631(c) applies.) All expenditures paid or incurred by the taxpayer during the taxable year which are attributable to the making and administering of the contract disposing of the coal or iron ore and all expenditures paid or incurred during the taxable year in order to preserve the owner's economic interest retained under the contract shall be disallowed as deductions in computing taxable income for the taxable year. The sum of such expenditures and the adjusted depletion basis of the coal or iron ore disposed of in the taxable year shall be used in determining the amount of gain or loss with respect to the disposal. See §1.631–3. For special rule in case of loss, see paragraph (c) of this section. Section 272 and this section do not apply to capital expenditures, and such expenditures are not taken into account in computing gain or loss under section 631(c) except to the extent they are properly part of the depletable basis of the coal or iron ore.

(2) The expenditures covered under section 272 and this section are disallowed as a deduction only with respect to a taxable year in which income is realized under the coal royalty contract (or iron ore royalty contract) to which such expenditures are attributable. Where no income is realized under the contract in a taxable year, these expenditures shall be deducted as expenses for the production of income, or as a business expense, or they may be treated under section 266 (relating to taxes and carrying charges) if applicable.

(3) The provisions of section 272 and this section apply to a taxable year in which income from the disposal by the owner of coal or iron ore held by him for more than 1 year (6 months for taxable years beginning before 1977; 9 months for taxable years beginning in 1977) is subject to the provisions of section 631(c) even though the actual mining of coal or iron ore under the coal royalty contract (or iron ore royalty contract) does not take place during the taxable year. Where the right under the contract to mine coal or iron ore for which advance payment has been made expires, terminates, or is abandoned before the coal or iron ore is mined, and paragraph (c) of §1.631–3 requires the owner to recompute his tax with respect to such payment, the recomputation must be made without applying the provisions of section 272 and this section.

(c) *Losses.* If, in any taxable year, the expenditures referred to in section 272 and this section plus the adjusted depletion basis (as defined in paragraph (b)(2) of §1.631–3) of the coal or iron ore disposed of during the taxable year exceed the amount realized under the contract which is subject to section 631(c) during the taxable year, such excess shall be considered under section 1231 as a loss from the sale of property used in the trade or business and, to the extent not availed of as a reduction of gain under that section, shall be a loss deductible under section 165(a) (relating to the deduction of losses generally).

(d) *Examples of expenditures.* (1) The expenditures referred to in section 272 include, but are not limited to, the following items, if such items are attributable to the making or administering of the contract or preserving the economic interest therein: Ad valorem taxes imposed by State or local authorities, costs of fire protection, costs of insurance (other than liability insurance), costs incurred in administering the contract (including costs of bookkeeping and technical supervision), interest on loans, expenses of flood control, legal and technical expenses, and expenses of measuring and checking quantities of coal or iron ore disposed of under the contract. Whether the interest on loans is attributable to the making or administering of the contract or preserving the economic interest therein will depend upon the use to which the borrowed monies are put.

(2) Any expenditure referred to in this section which is applicable to more than one coal royalty contract or iron ore royalty contract shall be reasonably apportioned to each of such contracts. Furthermore, if an expenditure applies only in part to the making or administering of the contract or the preservation of the economic interest, then only such part shall be treated under section 272. The apportionment of the expenditure shall be made on a reasonable basis. For example, where a taxpayer has other income (such as income from oil or gas royalties, rentals, right of way fees, interest, or dividends) as well as income under section 631(c), and where the salaries of some of its employees or other expenses relate to both classes of income, such expenses shall be allocated reasonably between the income subject to section

631(c) and the other income. Where a taxpayer has more than one coal royalty contract or iron ore royalty contract, expenditures under this section relating to a contract from which no income has been received in the taxable year may not be allocated to income from another contract from which income has been received in the taxable year.

(3) The taxpayer may have expenses which are not attributable even partly to making and administering a coal royalty contract or iron ore royalty contract or to the preservation of the economic interest retained under the contract and, accordingly, are not included in the expenditures described in section 272. These include such items as ad valorem taxes imposed by State or local authorities on property not covered by the contract, salaries, wages, or other expenses entirely incident to the ownership and protection of such property and depreciation of improvements thereon, fire insurance on such property, charitable contributions, and similar expenses unrelated to the making or to the administering of coal royalty contracts or iron ore royalty contracts or preserving the taxpayer's economic interest retained therein.

(e) *Nonapplication of section.* For purposes of section 543, the provisions of section 272 shall have no application. For example, the taxpayer may, for the purposes of section 543(a)(3)(C) or the corresponding provisions of prior income tax laws, include in the sum of the deductions which are allowable under section 162 an amount paid to an attorney as compensation for legal services rendered in connection with the making of a coal royalty contract or iron ore royalty contract (assuming the expenditure otherwise qualifies under section 162 as an ordinary and necessary expense incurred in the taxpayer's trade or business), even though such expenditure is disallowed as a deduction under section 272.

[T.D. 6841, 30 FR 9304, July 27, 1965, as amended by T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.273–1 Life or terminable interests.

(a) *In general.* Amounts paid as income to the holder of a life or a terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called by depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time. For the treatment generally of distributions to beneficiaries of an estate or trust, see Subparts A, B, C, and D (section 641 and following), Subchapter J, Chapter 1 of the Code, and the regulations thereunder. For basis of property acquired from a decedent and by gifts and transfers in trust, see sections 1014, 1015, and 1022, and the regulations thereunder.

(b) *Effective/applicability date.* The provisions in this section are applicable for taxable years beginning on or after September 16, 1958. The provisions of this section relating to section 1022 are effective on and after January 19, 2017.

[T.D. 9811, 82 FR 6237, Jan. 19, 2017]

§ 1.274–1 Disallowance of certain entertainment, gift and travel expenses.

Section 274 disallows in whole, or in part, certain expenditures for entertainment, gifts and travel which would otherwise be allowable under Chapter 1 of the Code. The requirements imposed by section 274 are in addition to the requirements for deductibility imposed by other provisions of the Code. If a deduction is claimed for an expenditure for entertainment, gifts, or travel, the taxpayer must first establish that it is otherwise allowable as a deduction under Chapter 1 of the Code before the provisions of section 274 become applicable. An expenditure for entertainment, to the extent it is lavish or extravagant, shall not be allowable as a deduction. The taxpayer should then substantiate such an expenditure in accordance with the rules under section 274(d). See §1.274–5. Section 274 is a disallowance provision exclusively, and does not make deductible any expense which is disallowed under any other provision of the Code. Similarly, section 274 does not affect the includability of an item in, or the excludability of an item from, the gross income of any taxpayer. For specific provisions with respect to the deductibility of expenditures: for an activity of a type generally considered to constitute entertainment, amusement, or recreation, and for a facility used in connection with such an activity, as well as certain travel expenses of a spouse, etc., see §1.274–2; for expenses for gifts, see §1.274–3; for expenses for foreign travel, see §1.274–4; for expenditures deductible without regard to business activity, see §1.274–6; and for treatment of personal portion of entertainment facility, see §1.274–7.

[T.D. 6659, 28 FR 6499, June 25, 1963, as amended by T.D. 8666, 61 FR 27006, May 30, 1996]

§1.274–2 Disallowance of deductions for certain expenses for entertainment, amusement, recreation, or travel.

(a) *General rules*—(1) *Entertainment activity.* Except as provided in this section, no deduction otherwise allowable under Chapter 1 of the Code shall be allowed for any expenditure with respect to entertainment unless the taxpayer establishes:

(i) That the expenditure was directly related to the active conduct of the taxpayer's trade or business, or

(ii) In the case of an expenditure directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that the expenditure was associated with the active conduct of the taxpayer's trade or business.

Such deduction shall not exceed the portion of the expenditure directly related to (or in the case of an expenditure described in subdivision (ii) of this subparagraph, the portion of the expenditure associated with) the active conduct of the taxpayer's trade or business.

(2) *Entertainment facilities*—(i) *Expenditures paid or incurred after December 31, 1978, and not with respect to a club.* Except as provided in this section with respect to a club, no deduction otherwise allowable under chapter 1 of the Code shall be allowed for any expenditure paid or incurred after December 31, 1978, with respect to a facility used in connection with entertainment.

(ii) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities, or paid or incurred before January 1, 1994, with respect to clubs*—(*a*) *Requirements for deduction.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for any expenditure paid or incurred before January 1, 1979, with respect to a facility used in connection with entertainment, or for any expenditure paid or incurred before January 1, 1994, with respect to a club used in connection with entertainment, unless the taxpayer establishes—

(*1*) That the facility or club was used primarily for the furtherance of the taxpayer's trade or business; and

(*2*) That the expenditure was directly related to the active conduct of that trade or business.

(*b*) *Amount of deduction.* The deduction allowable under paragraph (a)(2)(ii)(*a*) of this section shall not exceed the portion of the expenditure directly related to the active conduct of the taxpayer's trade or business.

(iii) *Expenditures paid or incurred after December 31, 1993, with respect to a club*—(*a*) *In general.* No deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for amounts paid or incurred after December 31, 1993, for membership in any club organized for business, pleasure, recreation, or other social purpose. The purposes and activities of a club, and not its name, determine whether it is organized for business, pleasure, recreation, or other social purpose. Clubs organized for business, pleasure, recreation, or other social purpose include any membership organization if a principal purpose of the organization is to conduct entertainment activities for members of the organization or their guests or to provide members or their guests with access to entertainment facilities within the meaning of paragraph (e)(2) of this section. Clubs organized for business, pleasure, recreation, or other social purpose include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussion.

(*b*) *Exceptions.* Unless a principal purpose of the organization is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities, business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (such as bar associations and medical associations), and civic or public service organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose.

(3) *Cross references.* For definition of the term *entertainment,* see paragraph (b)(1) of this section. For the disallowance of deductions for the cost of admission to a dinner or program any part of the proceeds of which inures to the use of a political party or political candidate, and cost of admission to an inaugural event or similar event identified with any political party or political candidate, see §1.276–1. For rules and definitions with respect to:

(i) ''Directly related entertainment'', see paragraph (c) of this section,

(ii) ''Associated entertainment'', see paragraph (d) of this section,

(iii) ''Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs'', see paragraph (e) of this section, and

(iv) ''Specific exceptions'' to the disallowance rules of this section, see paragraph (f) of this section.

(b) *Definitions*—(1) *Entertainment defined*—(i) *In general.* For purposes of this section, the term *entertainment* means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. The term *entertainment* may include an activity, the cost of which is claimed as a business expense by the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing food and beverages, a hotel suite, or an automobile to a business customer or his family. The term *entertainment* does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as (*a*) supper money provided by an employer to his employee working overtime, (*b*) a hotel room maintained by an employer for lodging of his employees while in business travel status, or (*c*) an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to his employee who is on vacation would constitute entertainment of the employee.

(ii) *Objective test.* An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that *entertainment* means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business shall be considered. Thus, although attending a theatrical performance would generally be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in his professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce his products to a group of store buyers, the show would not be generally considered to constitute entertainment. However, if an appliance distributor conducts a fashion show for the wives of his retailers, the fashion show would be generally considered to constitute entertainment.

(iii) *Special definitional rules—(a) In general.* Except as otherwise provided in (*b*) or (*c*) of this subdivision, any expenditure which might generally be considered either for a gift or entertainment, or considered either for travel or entertainment, shall be considered an expenditure for entertainment rather than for a gift or travel.

(*b*) *Expenditures deemed gifts.* An expenditure described in (*a*) of this subdivision shall be deemed for a gift to which this section does not apply if it is:

(*1*) An expenditure for packaged food or beverages transferred directly or indirectly to another person intended for consumption at a later time.

(*2*) An expenditure for tickets of admission to a place of entertainment transferred to another person if the taxpayer does not accompany the recipient to the entertainment unless the taxpayer treats the expenditure as entertainment. The taxpayer may change his treatment of such an expenditure as either a gift or entertainment at any time within the period prescribed for assessment of tax as provided in section 6501 of the Code and the regulations thereunder.

(*3*) Such other specific classes of expenditure generally considered to be for a gift as the Commissioner, in his discretion, may prescribe.

(*c*) *Expenditures deemed travel.* An expenditure described in (*a*) of this subdivision shall be deemed for travel to which this section does not apply if it is:

(*1*) With respect to a transportation type facility (such as an automobile or an airplane), even though used on other occasions in connection with an activity of a type generally considered to constitute entertainment, to the extent the facility is used in pursuit of a trade or business for purposes of transportation not in connection with entertainment. See also paragraph (e)(3)(iii)(*b*) of this section for provisions covering nonentertainment expenditures with respect to such facilities.

(*2*) Such other specific classes of expenditure generally considered to be for travel as the Commissioner, in his discretion, may prescribe.

(2) *Other definitions*—(i) *Expenditure.* The term *expenditure* as used in this section shall include expenses paid or incurred for goods, services, facilities, and items (including items such as losses and depreciation).

(ii) *Expenses for production of income.* For purposes of this section, any reference to *trade or business* shall include any activity described in section 212.

(iii) *Business associate.* The term *business associate* as used in this section means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.

(c) *Directly related entertainment*—(1) *In general.* Except as otherwise provided in paragraph (d) of this section (relating to associated entertainment) or under paragraph (f) of this section (relating to business meals and other specific exceptions), no deduction shall be allowed for any expenditure for entertainment unless the taxpayer establishes that the expenditure was directly related to the active conduct of his trade or business within the meaning of this paragraph.

(2) *Directly related entertainment defined.* Any expenditure for entertainment, if it is otherwise allowable as a deduction under chapter 1 of the Code, shall be considered directly related to the active conduct of the taxpayer's trade or business if it meets the requirements of any one of subparagraphs (3), (4), (5), or (6) of this paragraph.

(3) *Directly related in general.* Except as provided in subparagraph (7) of this paragraph, an expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that it meets all of the requirements of subdivisions (i), (ii), (iii) and (iv) of this subparagraph.

(i) At the time the taxpayer made the entertainment expenditure (or committed himself to make the expenditure), the taxpayer had more than a general expectation of deriving some income or other specific trade or business benefit (other than the goodwill of the person or persons entertained) at some indefinite future time from the making of the expenditure. A taxpayer, however, shall not be required to show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed.

(ii) During the entertainment period to which the expenditure related, the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining such income or other specific trade or business benefit (or, at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that he would have done so, although such was not the case solely for reasons beyond the taxpayer's control).

(iii) In light of all the facts and circumstances of the case, the principal character or aspect of the combined business and entertainment to which the expenditure related was the active conduct of the taxpayer's trade or business (or at the time the taxpayer made the expenditure or committed himself to the expenditure, it was reasonable for the taxpayer to expect that the active conduct of trade or business would have been the principal character or aspect of the entertainment, although such was not the case solely for reasons beyond the taxpayer's control). It is not necessary that more time be devoted to business than to entertainment to meet this requirement. The active conduct of trade or business is considered not to be the principal character or aspect of combined business and entertainment activity on hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary.

(iv) The expenditure was allocable to the taxpayer and a person or persons with whom the taxpayer engaged in the active conduct of trade or business during the entertainment or with whom the taxpayer establishes he would have engaged in such active conduct of trade or business if it were not for circumstances beyond the taxpayer's control. For expenditures closely connected with directly related entertainment, see paragraph (d)(4) of this section.

(4) *Expenditures in clear business setting.* An expenditure for entertainment shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was for entertainment occurring in a clear business setting directly in furtherance of the taxpayer's trade or business. Generally, entertainment shall not be considered to have occurred in a clear business setting unless the taxpayer clearly establishes that any recipient of the entertainment would have reasonably known that the taxpayer had no significant motive, in incurring the expenditure, other than directly furthering his trade or business. Objective rather than subjective standards will be determinative. Thus, entertainment which occurred under any circumstances described in subparagraph (7)(ii) of this paragraph ordinarily will not be considered as occurring in a clear business setting. Such entertainment will generally be considered to be socially rather than commercially motivated. Expenditures made for the furtherance of a taxpayer's trade or business in providing a ''hospitality room'' at a convention (described in paragraph (d)(3)(i)(*b*) of this section) at which goodwill is created through display or discussion of the taxpayer's products, will, however, be treated as directly related. In addition, entertainment of a clear business nature which occurred under circumstances where there was no meaningful personal or social relationship between the taxpayer and the recipients of the entertainment may be considered to have occurred in a clear business setting. For example, entertainment of business representatives and civic leaders at the opening of a new hotel or theatrical production, where the clear purpose of the taxpayer is to obtain business publicity rather than to create or maintain the goodwill of the recipients of the entertainment, would generally be considered to be in a clear business setting. Also, entertainment which has the principal effect of a price rebate in connection with the sale of the taxpayer's products generally will be considered to have occurred in a clear business setting. Such would be the case, for example, if a taxpayer owning a hotel were

to provide occasional free dinners at the hotel for a customer who patronized the hotel.

(5) *Expenditures for services performed.* An expenditure shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was made directly or indirectly by the taxpayer for the benefit of an individual (other than an employee), and if such expenditure was in the nature of compensation for services rendered or was paid as a prize or award which is required to be included in gross income under section 74 and the regulations thereunder. For example, if a manufacturer of products provides a vacation trip for retailers of his products who exceed sales quotas as a prize or award which is includible in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer's trade or business.

(6) *Club dues, etc., allocable to business meals.* An expenditure shall be considered directly related to the active conduct of the taxpayer's trade or business if it is established that the expenditure was with respect to a facility (as described in paragraph (e) of this section) used by the taxpayer for the furnishing of food or beverages under circumstances described in paragraph (f)(2)(i) of this section (relating to business meals and similar expenditures), to the extent allocable to the furnishing of such food or beverages. This paragraph (c)(6) applies to club dues paid or incurred before January 1, 1987.

(7) *Expenditures generally considered not directly related.* Expenditures for entertainment, even if connected with the taxpayer's trade or business, will generally be considered not directly related to the active conduct of the taxpayer's trade or business, if the entertainment occurred under circumstances where there was little or no possibility of engaging in the active conduct of trade or business. The following circumstances will generally be considered circumstances where there was little or no possibility of engaging in the active conduct of a trade or business:

(i) The taxpayer was not present;

(ii) The distractions were substantial, such as:

(*a*) A meeting or discussion at night clubs, theaters, and sporting events, or during essentially social gatherings such as cocktail parties, or

(*b*) A meeting or discussion, if the taxpayer meets with a group which includes persons other than business associates, at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts.

An expenditure for entertainment in any such case is considered not to be directly related to the active conduct of the taxpayer's trade or business unless the taxpayer clearly establishes to the contrary.

(d) *Associated entertainment*—(1) *In general.* Except as provided in paragraph (f) of this section (relating to business meals and other specific exceptions) and subparagraph (4) of this paragraph (relating to expenditures closely connected with directly related entertainment), any expenditure for entertainment which is not directly related to the active conduct of the taxpayer's trade or business will not be allowable as a deduction unless:

(i) It was associated with the active conduct of trade or business as defined in subparagraph (2) of this paragraph, and

(ii) The entertainment directly preceded or followed a substantial and bona fide business discussion as defined in subparagraph (3) of this paragraph.

(2) *Associated entertainment defined.* Generally, any expenditure for entertainment, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer's trade or business if the taxpayer establishes that he had a clear business purpose in making the expenditure, such as to obtain new business or to encourage the continuation of an existing business relationship. However, any portion of an expenditure allocable to a person who was not closely connected with a person who engaged in the substantial and bona fide business discussion (as defined in subparagraph (3)(i) of this paragraph) shall not be considered associated with the active conduct of the taxpayer's trade or business. The portion of an expenditure allocable to the spouse of a person who engaged in the

discussion will, if it is otherwise allowable under chapter 1 of the Code, be considered associated with the active conduct of the taxpayer's trade or business.

(3) *Directly preceding or following a substantial and bona fide business discussion defined*—(i) *Substantial and bona fide business discussion*—(*a*) *In general.* Whether any meeting, negotiation or discussion constitutes a ''substantial and bona fide business discussion'' within the meaning of this section depends upon the facts and circumstances of each case. It must be established, however, that the taxpayer actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction, other than entertainment, for the purpose of obtaining income or other specific trade or business benefit. In addition, it must be established that such a business meeting, negotiation, discussion, or transaction was substantial in relation to the entertainment. This requirement will be satisfied if the principal character or aspect of the combined entertainment and business activity was the active conduct of business. However, it is not necessary that more time be devoted to business than to entertainment to meet this requirement.

(*b*) *Meetings at conventions, etc.* Any meeting officially scheduled in connection with a program at a convention or similar general assembly, or at a bona fide trade or business meeting sponsored and conducted by business or professional organizations, shall be considered to constitute a substantial and bona fide business discussion within the meaning of this section provided:

(*1*) *Expenses necessary to taxpayer's attendance.* The expenses necessary to the attendance of the taxpayer at the convention, general assembly, or trade or business meeting, were ordinary and necessary within the meaning of section 162 or 212;

(*2*) *Convention program.* The organization which sponsored the convention, or trade or business meeting had scheduled a program of business activities (including committee meetings or presentation of lectures, panel discussions, display of products, or other similar activities), and that such program was the principal activity of the convention, general assembly, or trade or business meeting.

(ii) *Directly preceding or following.* Entertainment which occurs on the same day as a substantial and bona fide business discussion (as defined in subdivision (i) of this subparagraph) will be considered to directly precede or follow such discussion. If the entertainment and the business discussion do not occur on the same day, the facts and circumstances of each case are to be considered, including the place, date and duration of the business discussion, whether the taxpayer or his business associates are from out of town, and, if so, the date of arrival and departure, and the reasons the entertainment did not take place on the day of the business discussion. For example, if a group of business associates comes from out of town to the taxpayer's place of business to hold a substantial business discussion, the entertainment of such business guests and their wives on the evening prior to, or on the evening of the day following, the business discussion would generally be regarded as directly preceding or following such discussion.

(4) *Expenses closely connected with directly related entertainment.* If any portion of an expenditure meets the requirements of paragraph (c)(3) of this section (relating to directly related entertainment in general), the remaining portion of the expenditure, if it is otherwise allowable under Chapter 1 of the Code, shall be considered associated with the active conduct of the taxpayer's trade or business to the extent allocable to a person or persons closely connected with a person referred to in paragraph (c)(3)(iv) of this section. The spouse of a person referred to in paragraph(c)(3)(iv) of this section will be considered closely connected to such a person for purposes of this subparagraph. Thus, if a taxpayer and his wife entertain a business customer and the customer's wife under circumstances where the entertainment of the customer is considered directly related to the active conduct of the taxpayer's trade or business (within the meaning of paragraph (c)(3) of this section) the portion of the expenditure allocable to both wives will be considered associated with the active conduct of the

taxpayer's trade or business under this subparagraph.

(e) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs*—(1) *In general.* Any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with entertainment shall not be allowed as a deduction except to the extent it meets the requirements of paragraph (a)(2)(ii) of this section.

(2) *Facilities used in connection with entertainment*—(i) *In general.* Any item of personal or real property owned, rented, or used by a taxpayer shall (unless otherwise provided under the rules of subdivision (ii) of this subparagraph) be considered to constitute a facility used in connection with entertainment if it is used during the taxable year for, or in connection with, entertainment (as defined in paragraph (b)(1) of this section). Examples of facilities which might be used for, or in connection with, entertainment include yachts, hunting lodges, fishing camps, swimming pools, tennis courts, bowling alleys, automobiles, airplanes, apartments, hotel suites, and homes in vacation resorts.

(ii) *Facilities used incidentally for entertainment.* A facility used only incidentally during a taxable year in connection with entertainment, if such use is insubstantial, will not be considered a ''facility used in connection with entertainment'' for purposes of this section or for purposes of the recordkeeping requirements of section 274(d). See § 1.274–5(c)(6)(iii).

(3) *Expenditures with respect to a facility used in connection with entertainment*—(i) *In general.* The phrase *expenditures with respect to a facility used in connection with entertainment* includes depreciation and operating costs, such as rent and utility charges (for example, water or electricity), expenses for the maintenance, preservation or protection of a facility (for example, repairs, painting, insurance charges), and salaries or expenses for subsistence paid to caretakers or watchmen. In addition, the phrase includes losses realized on the sale or other disposition of a facility.

(ii) *Club dues*—(*a*) *Club dues paid or incurred before January 1, 1994.* Dues or fees paid before January 1, 1994, to any social, athletic, or sporting club or organization are considered expenditures with respect to a facility used in connection with entertainment. The purposes and activities of a club or organization, and not its name, determine its character. Generally, the phrase *social, athletic, or sporting club or organization* has the same meaning for purposes of this section as that phrase had in section 4241 and the regulations thereunder, relating to the excise tax on club dues, prior to the repeal of section 4241 by section 301 of Public Law 89–44. However, for purposes of this section only, clubs operated solely to provide lunches under circumstances of a type generally considered to be conducive to business discussion, within the meaning of paragraph (f)(2)(i) of this section, will not be considered social clubs.

(*b*) *Club dues paid or incurred after December 31, 1993.* See paragraph (a)(2)(iii) of this section with reference to the disallowance of deductions for club dues paid or incurred after December 31, 1993.

(iii) *Expenditures not with respect to a facility.* The following expenditures shall not be considered to constitute expenditures with respect to a facility used in connection with entertainment:

(*a*) *Out of pocket expenditures.* Expenses (exclusive of operating costs and other expenses referred to in subdivision (i) of this subparagraph) incurred at the time of an entertainment activity, even though in connection with the use of facility for entertainment purposes, such as expenses for food and beverages, or expenses for catering, or expenses for gasoline and fishing bait consumed on a fishing trip;

(*b*) *Non-entertainment expenditures.* Expenses or items attributable to the use of a facility for other than entertainment purposes such as expenses for an automobile when not used for entertainment; and

(*c*) *Expenditures otherwise deductible.* Expenses allowable as a deduction without regard to their connection with a taxpayer's trade or business such as taxes, interest, and casualty losses. The provisions of this subdivision shall be applied in the case of a taxpayer which is not an individual as if it were an individual. See also § 1.274–6.

(iv) *Cross reference.* For other rules with respect to treatment of certain expenditures for entertainment-type facilities, see § 1.274–7.

(4) *Determination of primary use*—(i) *In general.* A facility used in connection with entertainment shall be considered as used primarily for the furtherance of the taxpayer's trade or business only if it is established that the primary use of the facility during the taxable year was for purposes considered ordinary and necessary within the meaning of sections 162 and 212 and the regulations thereunder. All of the facts and circumstances of each case shall be considered in determining the primary use of a facility. Generally, it is the actual use of the facility which establishes the deductibility of expenditures with respect to the facility; not its availability for use and not the taxpayer's principal purpose in acquiring the facility. Objective rather than subjective standards will be determinative. If membership entitles the member's entire family to use of a facility, such as a country club, their use will be considered in determining whether business use of the facility exceeds personal use. The factors to be considered include the nature of each use, the frequency and duration of use for business purposes as compared with other purposes, and the amount of expenditures incurred during use for business compared with amount of expenditures incurred during use for other purposes. No single standard of comparison, or quantitative measurement, as to the significance of any such factor, however, is necessarily appropriate for all classes or types of facilities. For example, an appropriate standard for determining the primary use of a country club during a taxable year will not necessarily be appropriate for determining the primary use of an airplane. However, a taxpayer shall be deemed to have established that a facility was used primarily for the furtherance of his trade or business if he establishes such primary use in accordance with subdivision (ii) or (iii) of this subparagraph. Subdivisions (ii) and (iii) of this subparagraph shall not preclude a taxpayer from otherwise establishing the primary use of a facility under the general provisions of this subdivision.

(ii) *Certain transportation facilities.* A taxpayer shall be deemed to have established that a facility of a type described in this subdivision was used primarily for the furtherance of his trade or business if:

(*a*) *Automobiles.* In the case of an automobile, the taxpayer establishes that more than 50 percent of mileage driven during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(*b*) *Airplanes.* In the case of an airplane, the taxpayer establishes that more than 50 percent of hours flown during the taxable year was in connection with travel considered to be ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder.

(iii) *Entertainment facilities in general.* A taxpayer shall be deemed to have established that:

(*a*) A facility used in connection with entertainment, such as a yacht or other pleasure boat, hunting lodge, fishing camp, summer home or vacation cottage, hotel suite, country club, golf club or similar social, athletic, or sporting club or organization, bowling alley, tennis court, or swimming pool, or,

(*b*) A facility for employees not falling within the scope of section 274(e) (2) or (5) was used primarily for the furtherance of his trade or business if he establishes that more than 50 percent of the total calendar days of use of the facility by, or under authority of, the taxpayer during the taxable year were days of business use. Any use of a facility (of a type described in this subdivision) during one calendar day shall be considered to constitute a "day of business use" if the primary use of the facility on such day was ordinary and necessary within the meaning of section 162 or 212 and the regulations thereunder. For the purposes of this subdivision, a facility shall be deemed to have been primarily used for such pruposes on any one calendar day if the facility was used for the conduct of a substantial and bona fide business discussion (as defined in paragraph (d)(3)(i) of this section) notwithstanding that the facility may also have been used on the same day for personal or family use by the taxpayer or any member of the taxpayer's family not involving entertainment of others by, or under the authority of, the taxpayer.

(f) *Specific exceptions to application of this section*—(1) *In general.* The provisions of paragraphs (a) through (e) of this section (imposing limitations on deductions for entertainment expenses) are not applicable in the case of expenditures set forth in subparagraph (2) of this paragraph. Such expenditures are deductible to the extent allowable under chapter 1 of the Code. This paragraph shall not be construed to affect the allowability or nonallowability of a deduction under section 162 or 212 and the regulations thereunder. The fact that an expenditure is not covered by a specific exception provided for in this paragraph shall not be determinative of the allowability or nonallowability of the expenditure under paragraphs (a) through (e) of this section. Expenditures described in subparagraph (2) of this paragraph are subject to the substantiation requirements of section 274(d) to the extent provided in §1.274–5.

(2) *Exceptions.* The expenditures referred to in subparagraph (1) of this paragraph are set forth in subdivisions (i) through (ix) of this subparagraph.

(i) *Business meals and similar expenditures paid or incurred before January 1, 1987*—(*a*) *In general.* Any expenditure for food or beverages furnished to an individual under circumstances of a type generally considered conducive to business discussion (taking into account the surroundings in which furnished, the taxpayer's trade, business, or income-producing activity, and the relationship to such trade, business or activity of the persons to whom the food or beverages are furnished) is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. There is no requirement that business actually be discussed for this exception to apply.

(*b*) *Surroundings.* The surroundings in which the food or beverages are furnished must be such as would provide an atmosphere where there are no substantial distractions to discussion. This exception applies primarily to expenditures for meals and beverages served during the course of a breakfast, lunch or dinner meeting of the taxpayer and his business associates at a restaurant, hotel dining room, eating club or similar place not involving distracting influences such as a floor show. This exception also applies to expenditures for beverages served apart from meals if the expenditure is incurred in surroundings similarly conducive to business discussion, such as an expenditure for beverages served during the meeting of the taxpayer and his business associates at a cocktail lounge or hotel bar not involving distracting influences such as a floor show. This exception may also apply to expenditures for meals or beverages served in the taxpayer's residence on a clear showing that the expenditure was commercially rather than socially motivated. However, this exception, generally, is not applicable to any expenditure for meals or beverages furnished in circumstances where there are major distractions not conducive to business discussion, such as at night clubs, sporting events, large cocktail parties, sizeable social gatherings, or other major distracting influences.

(*c*) *Taxpayer's trade or business and relationship of persons entertained.* The taxpayer's trade, business, or income-producing activity and the relationship of the persons to whom the food or beverages are served to such trade, business or activity must be such as will reasonably indicate that the food or beverages were furnished for the primary purpose of furthering the taxpayer's trade or business and did not primarily serve a social or personal purpose. Such a business purpose would be indicated, for example, if a salesman employed by a manufacturing supply company meets for lunch during a normal business day with a purchasing agent for a manufacturer which is a prospective customer. Such a purpose would also be indicated if a life insurance agent meets for lunch during a normal business day with a client.

(*d*) *Business programs.* Expenditures for business luncheons or dinners which are part of a business program, or banquets officially sponsored by business or professional associations, will be regarded as expenditures to which the exception of this subdivision (i) applies. In the case of such a business luncheon or dinner it is not always necessary that the taxpayer attend the luncheon or dinner himself. For example, if a dental equipment supplier purchased a table at a dental association banquet for dentists who are actual or prospective customers for his equipment, the cost of the table would not be disallowed under this section. See also paragraph (c)(4) of this section relating to expenditures made in a clear business setting.

(ii) *Food and beverages for employees.* Any expenditure by a taxpayer for food and beverages (or for use of a facility in connection therewith) furnished on the taxpayer's business premises primarily for his employees is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies not only to expenditures for food or beverages furnished in a typical company cafeteria or an executive dining room, but also to expenditures with respect to the operation of such facilities. This exception applies even though guests are occasionally served in the cafeteria or dining room.

(iii) *Certain entertainment and travel expenses treated as compensation*—(A) *In general.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) or for travel described in section 274(m)(3), if an employee is the recipient of the entertainment or travel, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent that the expenditure is treated by the taxpayer—

(*1*) On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and

(*2*) As wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages).

(B) *Expenses includible in income of persons who are not employees.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith), or for travel described in section 274(m)(3), is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section to the extent the expenditure is includible in gross income as compensation for services rendered, or as a prize or award under section 74, by a recipient of the expenditure who is not an employee of the taxpayer. The preceding sentence shall not apply to any amount paid or incurred by the taxpayer if such amount is required to be included (or would be so required except that the amount is less that $600) in any information return filed by such taxpayer under part III of subchapter A of chapter 61 and is not so included. See section 274(e)(9).

(C) *Example.* The following example illustrates the provisions this paragraph (f):

Example. If an employer rewards the employee (and the employee's spouse) with an expense paid vacation trip, the expense is deductible by the employer (if otherwise allowable under section 162 and the regulations thereunder) to the extent the employer treats the expenses as compensation and as wages. On the other hand, if a taxpayer owns a yacht which the taxpayer uses for the entertainment of business customers, the portion of salary paid to employee members of the crew which is allocable to use of the yacht for entertainment purposes (even though treated on the taxpayer's tax return as compensation and treated as wages for withholding tax purposes) would not come within this exception since the members of the crew were not recipients of the entertainment. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder or if it constitutes unreasonable compensation paid to an employee, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Internal Revenue Code.

(iv) *Reimbursed entertainment, food, or beverage expenses*—(A) *Introduction.* In the case of any expenditure for entertainment, amusement, recreation, food, or beverages made by one person in performing services for another person (whether or not the other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. If an expenditure of a type described in this paragraph (f)(2)(iv) properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, a personal expense, or other nondeductible expense, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Code.

(B) *Reimbursement arrangements involving employees*. In the case of an employee's expenditure for entertainment, amusement, recreation, food, or beverages in performing services as an employee under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party), the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply—

(*1*) To the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and as wages to the employee for purposes of withholding under chapter 24 (relating to collection of income tax at source on wages); or

(*2*) To the payor to the extent the reimbursement or other payment of the expense is not treated as compensation and wages paid to the employee in the manner provided in paragraph (f)(2)(iv)(B)(*1*) of this section (however, see paragraph (f)(2)(iv)(C) of this section if the payor receives a payment from a third party that may be treated as a reimbursement arrangement under that paragraph).

(C) *Reimbursement arrangements involving persons that are not employees*. In the case of an expense for entertainment, amusement, recreation, food, or beverages of a person who is not an employee (referred to as an independent contractor) in performing services for another person (a client or customer) under a reimbursement or other expense allowance arrangement with the person, the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1) apply to the party expressly identified in an agreement between the parties as subject to the limitations. If an agreement between the parties does not expressly identify the party subject to the limitations, the limitations apply—

(*1*) To the independent contractor (which may be a payor described in paragraph (f)(2)(iv)(B) of this section) to the extent the independent contractor does not account to the client or customer within the meaning of section 274(d) and the associated regulations; or

(*2*) To the client or customer if the independent contractor accounts to the client or customer within the meaning of section 274(d) and the associated regulations. See also §1.274–5.

(D) *Reimbursement or other expense allowance arrangement*. The term *reimbursement or other expense allowance arrangement* means—

(*1*) For purposes of paragraph (f)(2)(iv)(B) of this section, an arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs; and

(*2*) For purposes of paragraph (f)(2)(iv)(C) of this section, an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either—

(*a*) A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions in paragraphs (a) through (e) of this section and section 274(n)(1); or

(*b*) A written agreement between the parties expressly identifies the party subject to the limitations.

(E) *Examples*. The following examples illustrate the application of this paragraph (f)(2)(iv).

Example 1. (i) Y, an employee, performs services under an arrangement in which L, an employee leasing company, pays Y a per diem allowance of $10x for each day that Y performs services for L's client, C, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food and beverages that Y pays in performing services as an employee. L enters into a written agreement with C under which C agrees to reimburse L for any substantiated reimbursements for travel expenses, including meals, that L pays to Y. The agreement does not expressly identify the party that is subject to the deduction limitations. Y performs services for C while traveling away from home for 10 days and provides L with substantiation that satisfies the requirements of section 274(d) of $100x of meal expenses incurred by Y while traveling away from home. L pays Y $100x to reimburse those expenses pursuant to their arrangement. L delivers a copy of Y's substantiation to C. C pays L $300x, which includes $200x compensation for services and $100x as reimbursement of L's payment of Y's travel expenses for meals. Neither L nor C treats the $100x paid to Y as compensation or wages.

(ii) Under paragraph (f)(2)(iv)(D)(*1*) of this section, Y and L have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to Y, under section 274(e)(3)(A) and paragraph (f)(2)(iv)(B)(*1*) of this section, Y is not subject to the section 274 deduction limitations. Instead, under paragraph (f)(2)(iv)(B)(*2*) of this section, L, the payor, is subject to the section 274 deduction limitations unless L can meet the requirements of section 274(e)(3)(B) and paragraph (f)(2)(iv)(C) of this section.

(iii) Because the agreement between L and C expressly states that C will reimburse L for substantiated reimbursements for travel expenses that L pays to Y, under paragraph (f)(2)(iv)(D)(*2*)(*a*) of this section, L and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(C) of this section. L accounts to C for C's reimbursement in the manner required by section 274(d) by delivering to C a copy of the substantiation L received from Y. Therefore, under section 274(e)(3)(B) and paragraph (f)(2)(iv)(C)(*2*) of this section, C and not L is subject to the section 274 deduction limitations.

Example 2. (i) The facts are the same as in *Example 1* except that, under the arrangements between Y and L and between L and C, Y provides the substantiation of the expenses directly to C, and C pays the per diem directly to Y.

(ii) Under paragraph (f)(2)(iv)(D)(*1*) of this section, Y and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(C) of this section. Because Y substantiates directly to C and the reimbursement payment was not treated as compensation and wages paid to Y, under section 274(e)(3)(A) and paragraph (f)(2)(iv)(C)(*1*) of this section Y is not subject to the section 274 deduction limitations. Under paragraph (f)(2)(iv)(C)(*2*) of this section, C, the payor, is subject to the section 274 deduction limitations.

Example 3. (i) The facts are the same as in *Example 1,* except that the written agreement between L and C expressly provides that the limitations of this section will apply to C.

(ii) Under paragraph (f)(2)(iv)(D)(*2*)(*b*) of this section, L and C have established a reimbursement or other expense allowance arrangement for purposes of paragraph (f)(2)(iv)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to C, under section 274(e)(3)(B) and paragraph (f)(2)(iv)(C) of this section, C and not L is subject to the section 274 deduction limitations.

Example 4. (i) The facts are the same as in *Example 1,* except that the agreement between L and C does not provide that C will reimburse L for travel expenses.

(ii) The arrangement between L and C is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (f)(2)(iv)(D)(*2*) of this section. Therefore, even though L accounts to C for the expenses, L is subject to the section 274 deduction limitations.

(F) *Effective/applicability date.* This paragraph (f)(2)(iv) applies to expenses paid or incurred in taxable years beginning after August 1, 2013.

(v) *Recreational expenses for employees generally.* Any expenditure by a taxpayer for a recreational, social, or similar activity (or for use of a facility in connection therewith), primarily for the benefit of his employees generally, is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. This exception applies only to expenditures made primarily for the benefit of employees of the taxpayer other than employees who are officers, shareholders on other owners who own a 10-percent or greater interest in the business, or other highly compensated employees. For purposes of the preceding sentence, an employee shall be treated as owning any interest owned by a member of his family (within the meaning of section 267(c)(4) and the regulations thereunder). Ordinarily, this exception applies to usual employee benefit programs such as expenses of a taxpayer (*a*) in holding Christmas parties, annual picnics, or summer outings, for his employees generally, or (*b*) of maintaining a swimming pool, baseball diamond, bowling alley, or golf course available to his employees generally. Any expenditure for an activity which is made under circumstances which discriminate in favor of employees who are officers, shareholders or other owners, or highly compensated employees shall not be considered made primarily for the benefit of employees generally. On the other hand, an expenditure for an activity will not be considered outside of this exception merely because, due to the large number of employees involved, the activity is intended to benefit only a limited number of such employees at one time, provided the activity does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees.

(vi) *Employee, stockholder, etc., business meetings.* Any expenditure by a taxpayer for entertainment which is directly related to bona fide business meetings of the taxpayer's employees, stockholders, agents, or directors held principally for discussion of trade or business is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. For purposes of this exception, a partnership is to be considered a taxpayer and a member of a partnership is to be considered an agent. For example, an expenditure by a taxpayer to furnish refreshments to his employees at a bona fide meeting, sponsored by the taxpayer for the principal purpose of instructing them with respect to a new procedure for conducting his business, would be within the provisions of this exception. A similar expenditure made at a bona fide meeting of stockholders of the taxpayer for the election of directors and discussion of corporate affairs would also be within the provisions of this exception. While this exception will apply to bona fide business meetings even though some social activities are provided, it will not apply to meetings which are primarily for social or nonbusiness purposes rather than for the transaction of the taxpayer's business. A meeting under circumstances where there was little or no possibility of engaging in the active conduct of trade or business (as described in paragraph (c)(7) of this section) generally will not be considered a business meeting for purposes of this subdivision. This exception will not apply to a meeting or convention of employees or agents, or similar meeting for directors, partners or others for the principal purpose of rewarding them for their services to the taxpayer. However, such a meeting or convention of employees might come within the scope of subdivisions (iii) or (v) of this subparagraph.

(vii) *Meetings of business leagues, etc.* Any expenditure for entertainment directly related and necessary to attendance at bona fide business meetings or conventions of organizations exempt from taxation under section 501(c)(6) of the Code, such as business leagues, chambers of commerce, real estate boards, boards of trade, and certain professional associations, is not subject to the limitations on allowability of deductions provided in paragraphs (a) through (e) of this section.

(viii) *Items available to the public.* Any expenditure by a taxpayer for entertainment (or for a facility in connection therewith) to the extent the entertainment is made available to the general public is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Expenditures for entertainment of the general public by means of television, radio, newspapers and the like, will come within this exception, as will expenditures for distributing samples to the general public. Similarly, expenditures for maintaining private parks, golf courses and similar facilities, to the extent that they are available for public use, will come within this exception. For example, if a corporation maintains a swimming pool which it makes available for a period of time each week to children participating in a local public recreational program, the portion of the expense relating to such public use of the pool will come within this exception.

(ix) *Entertainment sold to customers.* Any expenditure by a taxpayer for entertainment (or for use of a facility in connection therewith) to the extent the entertainment is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section. Thus, the cost of producing night club entertainment (such as salaries paid to employees of night clubs and amounts paid to performers) for sale to customers or the cost of operating a pleasure cruise ship as a business will come within this exception.

(g) *Additional provisions of section 274—travel of spouse, dependent or others.* Section 274(m)(3) provides that no deduction shall be allowed under this chapter (except section 217) for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless certain conditions are met. As provided in section 274(m)(3), the term *other individual* does not include a business associate (as defined in paragraph (b)(2)(iii) of this section) who otherwise meets the requirements of sections 274(m)(3)(B) and (C).

[T.D. 6659, 28 FR 6499, June 25, 1963, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 8051, 50 FR 36576, Sept. 9, 1985; T.D. 8601, 60 FR 36994, July 19, 1995; T.D. 8666, 61 FR 27006, May 30, 1996; T.D. 9625, 78 FR 46503, Aug. 1, 2013]

§ 1.274–3 Disallowance of deduction for gifts.

(a) *In general.* No deduction shall be allowed under section 162 or 212 for any expense for a gift made directly or indirectly by a taxpayer to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the taxpayer's taxable year, exceeds $25.

(b) *Gift defined*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph the term *gift,* for purposes of this section, means any item excludable from the gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of chapter 1 of the Code. Thus, a payment by an employer to a deceased employee's widow is not a gift, for purposes of this section, to the extent the payment constitutes an employee's death benefit excludable by the recipient under section 101(b). Similarly, a scholarship which is excludable from a recipient's gross income under section 117, and a prize or award which is excludable from a recipient's gross income under section 74(b), are not subject to the provisions of this section.

(2) *Items not treated as gifts.* The term *gift,* for purposes of this section, does not include the following:

(i) An item having a cost to the taxpayer not in excess of $4.00 on which the name of the taxpayer is clearly and permanently imprinted and which is one of a number of identical items distributed generally by such a taxpayer.

(ii) A sign, display rack, or other promotional material to be used on the business premises of the recipient, or

(iii) In the case of a taxable year of a taxpayer ending on or after August 13, 1981, an item of tangible personal property which is awarded before January 1, 1987, to an employee of the taxpayer by reason of the employee's length of service (including an award upon retirement), productivity, or safety achievement, but only to the extent that—

(A) The cost of the item to the taxpayer does not exceed $400; or

(B) The item is a qualified plan award (as defined in paragraph (d) of this section); or

(iv) In the case of a taxable year of a taxpayer ending before August 13, 1981, an item of tangible personal property having a cost to the taxpayer not in excess of $100 which is awarded to an employee of the taxpayer by reason of the employee's length of service (including an award upon retirement) or safety achievement.

For purposes of paragraphs (b)(2) (iii) and (iv) of this section, the term *tangible personal property* does not include cash or any gift certificate other than a nonnegotiable gift certificate conferring only the right to receive tangible personal property. Thus, for example, if a nonnegotiable gift certificate entitles an employee to choose between selecting an item of merchandise or receiving cash or reducing the balance due on his account with the issuer of the gift certificate, the gift certificate is not tangible personal property for purposes of this section. To the extent that an item is not treated as a gift for purposes of this section, the deductibility of the expense of the item is not governed by this section, and the taxpayer need not take such item into account in determining whether the $25 limitation on gifts to any individual has been exceeded. For example, if an employee receives by reason of his length of service a gift of an item of tangible personal property that costs the employer $450, the deductibility of only $50 ($450 minus $400) is governed by this section, and the employer takes the $50 into account for purposes of the $25 limitation on gifts to that employee. The fact that an item is wholly or partially excepted from the applicability of this section has no effect in determining whether the value of the item is includible in the gross income of the recipient. For rules relating to the taxability to the recipient of any item described in this subparagraph, see sections 61, 74, and 102 and the regulations thereunder. For rules relating to the deductibility of employee achievement awards awarded after December 31, 1986, see section 274 (j).

(c) *Expense for a gift.* For purposes of this section, the term *expense for a gift* means the cost of the gift to the taxpayer, other than incidental costs such as for customary engraving on jewelry, or for packaging, insurance, and mailing or other delivery. A related cost will be considered ''incidental'' only if it does not add substantial value to the gift. Although the cost of customary gift wrapping will be considered an incidental cost, the purchase of an ornamental basket for packaging fruit will not be considered an incidental cost of packaging if the basket has a value which is substantial in relation to the value of the fruit.

(d) *Qualified plan award*—(1) *In general.* Except as provided in subparagraph (2) of this paragraph the term *qualified plan award,* for purposes of this section, means an item of tangible personal property that is awarded to an employee by reason of the employee's length of service (including retirement), productivity, or safety achievement, and that is awarded pursuant to a permanent, written award plan or program of the taxpayer that does not discriminate as to eligibility or benefits in favor of employees who are officers, shareholders, or highly compensated employees. The ''permanency'' of an award plan shall be determined from all the facts and circumstances of the particular case, including the taxpayer's ability to continue to make the awards as required by the award plan. Although the taxpayer may reserve the right to change or to terminate an award plan, the actual termination of the award plan for any reason other than business necessity within a few years after it has taken effect may be evidence that the award plan from its inception was not a ''permanent'' award plan. Whether or not an award plan is discriminatory shall be determined from all the facts and circumstances of the particular case. An award plan may fail to qualify because it is discriminatory in its actual operation even though the written provisions of the award plan are not discriminatory.

(2) *Items not treated as qualified plan awards.* The term *qualified plan award,* for purposes of this section, does not include an item qualifying under paragraph (d)(1) of this section to the extent that the cost of the item exceeds $1,600. In addition, that term does not include any items qualifying under paragraph (d)(1) of this section if the average cost of all items (whether or not tangible personal property) awarded during the taxable year by the taxpayer under any plan described in paragraph (d)(1) of this section exceeds $400. The average cost of those items shall be computed by dividing (i) the sum of the costs for those items (including amounts in excess of the $1,600 limitation) by (ii) the total number of those items.

(e) *Gifts made indirectly to an individual*—(1) *Gift to spouse or member of family.* If a taxpayer makes a gift to the wife of a man who has a business connection with the taxpayer, the gift generally will be considered as made indirectly to the husband. However, if the wife has a bona fide business connection with the taxpayer independently of her relationship to her husband, a gift to her generally will not be considered as made indirectly to her husband unless the gift is intended for his eventual use or benefit. Thus, if a taxpayer makes a gift to a wife who is engaged with her husband in the active conduct of a partnership business, the gift to the wife will not be considered an indirect gift to her husband unless it is intended for his eventual use or benefit. The same rules apply to gifts to any other member of the family of an individual who has a business connection with the taxpayer.

(2) *Gift to corporation or other business entity.* If a taxpayer makes a gift to a corporation or other business entity intended for the eventual personal use or benefit of an individual who is an employee, stockholder, or other owner of the corporation or business entity, the gift generally will be considered as made indirectly to such individual. Thus, if a taxpayer provides theater tickets to a closely held corporation for eventual use by any one of the stockholders of the corporation, and if such tickets are gifts, the gifts will be considered as made indirectly to the individual who eventually uses such ticket. On the other hand, a gift to a business organization of property to be used in connection with the business of the organization (for example, a technical manual) will not be considered as a gift to an individual, even though, in practice, the book will be used principally by a readily identifiable individual employee. A gift for the eventual personal use or benefit of some undesignated member of a large group of individuals generally will not be considered as made indirectly to the individual who eventually uses, or benefits from, such gifts unless, under the circumstances of the case, it is reasonably practicable for the taxpayer to ascertain the ultimate recipient of the gift. Thus, if a taxpayer provides several baseball tickets to a corporation for the eventual use by any one of a large number of employees or customers of the corporation, and if such tickets are gifts, the gifts generally will not be treated as made indirectly to the individuals who use such tickets.

(f) *Special rules*—(1) *Partnership.* In the case of a gift by a partnership, the $25 annual limitation contained in paragraph (a) of this section shall apply to the partnership as well as to each member of the partnership. Thus, in the case of a gift made by a partner with respect to the business of the partnership, the $25 limitation will be applied at the partnership level as well as at the level of the individual partner. Consequently, deductions for gifts made with respect to partnership business will not exceed $25 annually for each recipient, regardless of the number of partners.

(2) *Husband and wife.* For purposes of applying the $25 annual limitation contained in paragraph (a) of this section, a husband and wife shall be treated as one taxpayer. Thus, in the case of gifts to an individual by a husband and wife, the spouses will be treated as one donor; and they are limited to a deduction of $25 annually for each recipient. This rule applies regardless of whether the husband and wife file a joint return or whether the husband and wife make separate gifts to an individual with respect to separate businesses. Since the term *taxpayer* in paragraph (a) of this section refers only to the donor of a gift, this special rule does not apply to treat a husband and wife as one individual where each is a recipient of a gift. See paragraph (e)(1) of this section.

(g) *Cross reference.* For rules with respect to whether this section or § 1.274–2 applies, see § 1.274–2(b)(1) (iii).

[T.D. 6659, 28 FR 6505, June 25, 1963, as amended by T.D. 8230, 53 FR 36451, Sept. 20, 1988]

§ 1.274–4 Disallowance of certain foreign travel expenses.

(a) *Introductory.* Section 274(c) and this section impose certain restrictions on the deductibility of travel expenses incurred in the case of an individual who, while traveling outside the United States away from home in the pursuit of trade or business (hereinafter termed ''business activity''), engages in substantial personal activity not attributable to such trade or business (hereinafter termed ''nonbusiness activity''). Section 274(c) and this section are limited in their application to individuals (whether or not an employee or other person traveling under a reimbursement or other expense allowance arrangement) who engage in nonbusiness activity while traveling outside the United States away from home, and do not impose restrictions on the deductibility of travel expenses incurred by an employer or client under an advance, reimbursement, or other arrangement with the individual who engages in nonbusiness activity. For purposes of this section, the term *United States* includes only the States and the District of Columbia, and any reference to ''trade or business'' or ''business activity'' includes any activity described in section 212. For rules governing the determination of travel outside the United States away from home, see paragraph (e) of this section. For rules governing the disallowance of travel expense to which this section applies, see paragraph (f) of this section.

(b) *Limitations on application of section.* The restrictions on deductibility of travel expenses contained in paragraph (f) of this section are applicable only if:

(1) The travel expense is otherwise deductible under section 162 or 212 and the regulations thereunder,

(2) The travel expense is for travel outside the United States away from home which exceeds 1 week (as determined under paragraph (c) of this section), and

(3) The time outside the United States away from home attributable to nonbusiness activity (as determined under paragraph (d) of this section) constitutes 25 percent or more of the total time on such travel.

(c) *Travel in excess of 1 week.* This section does not apply to an expense of travel unless the expense is for travel outside the United States away from home which exceeds 1 week. For purposes of this section, 1 week means 7 consecutive days. The day in which travel outside the United States away from home begins shall not be considered, but the day in which such travel ends shall be considered, in determining whether a taxpayer is outside the United States away from home for more than 7 consecutive days. For example, if a taxpayer departs on travel outside the United States away from home on a Wednesday morning and ends such travel the following Wednesday evening, he shall be considered as being outside the United States away from home only 7 consecutive days. In such a case, this section would not apply because the taxpayer was not outside the United States away from home for more than 7 consecutive days. However, if the taxpayer travels outside the United States away from home for more than 7 consecutive days, both the day such travel begins and the day such travel ends shall be considered a ''business day'' or a ''nonbusiness day'', as the case may be, for purposes of determining whether nonbusiness activity constituted 25 percent or more of travel time under paragraph (d) of this section and for purposes of allocating expenses under paragraph (f) of this section. For purposes of determining whether travel is outside the United States away from home, see paragraph (e) of this section.

(d) *Nonbusiness activity constituting 25 percent or more of travel time*—(1) *In general.* This section does not apply to any expense of travel outside the United States away from home unless the portion of time outside the United States away from home attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel.

(2) *Allocation on per day basis.* The total time traveling outside the United States away from home will be allocated on a day-by-day basis to (i) days of business activity or (ii) days of nonbusiness activity (hereinafter termed ''business days'' or ''nonbusiness days'' respectively) unless the taxpayer establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity. For purposes of this section, a day spent outside the United States away from home shall be deemed entirely a business day even though spent only in part on business activity if the taxpayer establishes:

(i) *Transportation days.* That on such day the taxpayer was traveling to or returning from a destination outside the United States away from home in the pursuit of trade or business. However, if for purposes of engaging in nonbusiness activity, the taxpayer while traveling outside the United States away from home does not travel by a reasonably direct route, only that number of days shall be considered business days as would be required for the taxpayer, using the same mode of transportation, to travel to or return from the same destination by a reasonably direct route. Also, if, while so traveling, the taxpayer interrupts the normal course of travel by engaging in substantial diversions for nonbusiness reasons of his own choosing, only that number of days shall be considered business days as equals the number of days required for the taxpayer, using the same mode of transportation, to travel to or return from the same destination without engaging in such diversion. For example, if a taxpayer residing in New York departs on an evening on a direct flight to Quebec for a business meeting to be held in Quebec the next morning, for purposes of determining whether nonbusiness activity constituted 25 percent or more of his travel time, the entire day of his departure shall be considered a business day. On the other hand, if a taxpayer travels by automobile from New York to Quebec to attend a business meeting and while en route spends 2 days in Ottawa and 1 day in Montreal on nonbusiness activities of his personal choice, only that number of days outside the United States shall be considered business days as would have been required for the taxpayer to drive by a reasonably direct route to Quebec, taking into account normal periods for rest and meals.

(ii) *Presence required.* That on such day his presence outside the United States away from home was required at a particular place for a specific and bona fide business purpose. For example, if a taxpayer is instructed by his employer to attend a specific business meeting, the day of the meeting shall be considered a business day even though, because of the scheduled length of the meeting, the taxpayer spends more time during normal working hours of the day on nonbusiness activity than on business activity.

(iii) *Days primarily business.* That during hours normally considered to be appropriate for business activity, his principal activity on such day was the pursuit of trade or business.

(iv) *Circumstances beyond control.* That on such day he was prevented from engaging in the conduct of trade or business as his principal activity due to circumstances beyond his control.

(v) *Weekends, holidays, etc.* That such day was a Saturday, Sunday, legal holiday, or other reasonably necessary standby day which intervened during that course of the taxpayer's trade or business while outside the United States away from home which the taxpayer endeavored to conduct with reasonable dispatch. For example, if a taxpayer travels from New York to London to take part in business negotiations beginning on a Wednesday and concluding on the following Tuesday, the intervening Saturday and Sunday shall be considered business days whether or not business is conducted on either of such days. Similarly, if in the above case the meetings which concluded on Tuesday evening were followed by business meetings with another business group in London on the immediately succeeding Thursday and Friday, the intervening Wednesday will be deemed a business day. However, if at the conclusion of the business meetings on Friday, the taxpayer stays in London for an additional week for personal purposes, the Saturday and Sunday following the conclusion of the business meeting will not be considered business days.

(e) *Domestic travel excluded*—(1) *In general.* For purposes of this section, travel outside the United States away from home does not include any travel from one point in the United States to another point in the United States. However, travel which is not from one point in the United States to another point in the United States shall be considered travel outside the United States. If a taxpayer travels from a place within the United States to a place outside the United States, the portion, if any, of such travel which is from one point in the United States to another point in the United States is to be disregarded for purposes of determining:

(i) Whether the taxpayer's travel outside the United States away from home exceeds 1 week (see paragraph (c) of this section),

(ii) Whether the time outside the United States away from home attributable to nonbusiness activity constitutes 25 percent or more of the total time on such travel (see paragraph (d) of this section), or

(iii) The amount of travel expense subject to the allocation rules of this section (see paragraph (f) of this section).

(2) *Determination of travel from one point in the United States to another point in the United States.* In the case of the following means of transportation, travel from one point in the United States to another point in the United States shall be determined as follows:

(i) *Travel by public transportation.* In the case of travel by public transportation, any place in the United States at which the vehicle makes a scheduled stop for the purpose of adding or discharging passengers shall be considered a point in the United States.

(ii) *Travel by private automobile.* In the case of travel by private automobile, any such travel which is within the United States shall be considered travel from one point in the United States to another point in the United States.

(iii) *Travel by private airplane.* In the case of travel by private airplane, any flight, whether or not constituting the entire trip, where both the takeoff and the landing are within the United States shall be considered travel from one point in the United States to another point in the United States.

(3) *Examples.* The provisions of subparagraph (2) may be illustrated by the following examples:

Example 1. Taxpayer A flies from Los Angeles to Puerto Rico with a brief scheduled stopover in Miami for the purpose of adding and discharging passengers and A returns by airplane nonstop to Los Angeles. The travel from Los Angeles to Miami is considered travel from one point in the United States to another point in the United States. The travel from Miami to Puerto Rico and from Puerto Rico to Los Angeles is not considered travel from one point in the United States to another point in the United States and, thus, is considered to be travel outside the United States away from home.

Example 2. Taxpayer B travels by train from New York to Montreal. The travel from New York to the last place in the United States where the train is stopped for the purpose of adding or discharging passengers is considered to be travel from one point in the United States to another point in the United States.

Example 3. Taxpayer C travels by automobile from Tulsa to Mexico City and back. All travel in the United States is considered to be travel from one point in the United States to another point in the United States.

Example 4. Taxpayer D flies nonstop from Seattle to Juneau. Although the flight passes over Canada, the trip is considered to be travel from one point in the United States to another point in the United States.

Example 5. If in *Example 4* above, the airplane makes a scheduled landing in Vancouver, the time spent in traveling from Seattle to Juneau is considered to be travel outside the United States away from home. However, the time spent in Juneau is not considered to be travel outside the United States away from home.

(f) *Application of disallowance rules*—(1) *In general.* In the case of expense for travel outside the United States away from home by an individual to which this section applies, except as otherwise provided in subparagraph (4) or (5) of this paragraph, no deduction shall be allowed for that amount of travel expense specified in subparagraph (2) or (3) of this paragraph (whichever is applicable) which is obtained by multiplying the total of such travel expense by a fraction:

(i) The numerator of which is the number of nonbusiness days during such travel, and

(ii) The denominator of which is the total number of business days and nonbusiness days during such travel.

For determination of ''business days'' and ''nonbusiness days'', see paragraph (d)(2) of this section.

(2) *Nonbusiness activity at, near, or beyond business destination.* If the place at which the individual engages in nonbusiness activity (hereinafter termed ''nonbusiness destination'') is at, near, or beyond the place to which he travels in the pursuit of a trade or business (hereinafter termed ''business destination''), the amount of travel expense referred to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or section 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the business destination, and returning. Thus, if the individual travels from New York to London on business, and then takes a vacation in Paris before returning to New York, the amount of the travel expense subject to allocation is the expense which would have been incurred in traveling from New York to London and returning.

(3) *Nonbusiness activity on the route to or from business destination.* If the nonbusiness destination is on the route to or from the business destination, the amount of the travel expense referred to in subparagraph (1) of this paragraph shall be the amount of travel expense, otherwise allowable as a deduction under section 162 or 212, which would have been incurred in traveling from the place where travel outside the United States away from home begins to the nonbusiness destination and returning. Thus, if the individual travels on business from Chicago to Rio de Janeiro, Brazil with a scheduled stop in New York for the purpose of adding and discharging passengers, and while en route stops in Caracas, Venezuela for a vacation and returns to Chicago from Rio de Janeiro with another scheduled stop in New York for the purpose of adding and discharging passengers, the amount of travel expense subject to allocation is the expense which would have been incurred in traveling from New York to Caracas and returning.

(4) *Other allocation method.* If a taxpayer establishes that a method other than allocation on a day-by-day basis (as determined under paragraph (d)(2) of this section) more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity, the amount of travel expense for which no deduction shall be allowed shall be determined by such other method.

(5) *Travel expense deemed entirely allocable to business activity.* Expenses of travel shall be considered allocable in full to business activity, and no portion of such expense shall be subject to disallowance under this section, if incurred under circumstances provided for in subdivision (i) or (ii) of this subparagraph.

(i) *Lack of control over travel.* Expenses of travel otherwise deductible under section 162 or 212 shall be considered fully allocable to business activity if, considering all the facts and circumstances, the individual incurring such expenses did not have substantial control over the arranging of the business trip. A person who is required to travel to a business destination will not be considered to have substantial control over the arranging of the business trip merely because he has control over the timing of the trip. Any individual who travels on behalf of his employer under a reimbursement or other expense allowance arrangement shall be considered not to have had substantial control over the arranging of his business trip, provided the employee is not:

(*a*) A managing executive of the employer for whom he is traveling (and for this purpose the term *managing executive* includes only an employee who, by reason of his authority and responsibility, is authorized, without effective veto procedures, to decide upon the necessity for his business trip), or

(*b*) Related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent.

(ii) *Lack of major consideration to obtain a vacation.* Any expense of travel, which qualifies for deduction under section 162 or 212, shall be considered fully allocable to business activity if the individual incurring such expenses can establish that, considering all the facts and circumstances, he did not have a major consideration, in determining to make the trip, of obtaining a personal vacation or holiday. If such a major consideration were present, the provisions of subparagraphs (1) through (4) of this paragraph shall apply. However, if the trip were primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. See paragraph (b) of §1.162–2.

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

Example 1. Individual A flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days for travel en route, took 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 2. Individual B flew from Tampa to Honolulu (from one point in the United States to another point in the United States) for a business meeting which lasted 3 days and for personal matters which took 10 days.

He then flew to Melbourne, Australia where he conducted business for 2 days and went sightseeing for 1 day. Immediately thereafter he flew back to Tampa, with a scheduled landing in Honolulu for the purpose of adding and discharging passengers. Although the trip exceeded 1 week, the time spent outside the United States away from home, including 2 days for traveling from Honolulu to Melbourne and return, was 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

Example 3. Individual C flew from Los Angeles to New York where he spent 5 days. He then flew to Brussels where he spent 14 days on business and 5 days on personal matters. He then flew back to Los Angeles by way of New York. The entire trip, including 4 days for travel en route, took 28 days. However, the 2 days spent traveling from Los Angeles to New York and return, and the 5 days spent in New York are not considered travel outside the United States away from home and, thus, are disregarded for purposes of this section. Although the time spent outside the United States away from home exceeded 1 week, the time outside the United States away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time outside the United States away from home during the trip. Therefore, the disallowance rules of this section do not apply.

Example 4. D, an employee of Y Company, who is neither a managing executive of, nor related to, Y Company within the meaning of paragraph (f)(5)(i) of this section, traveled outside the United States away from home on behalf of his employer and was reimbursed by Y for his traveling expense to and from the business destination. The trip took more than a week and D took advantage of the opportunity to enjoy a personal vacation which exceeded 25 percent of the total time on the trip. Since D, traveling under a reimbursement arrangement, is not a managing executive of, or related to, Y Company, he is not considered to have substantial control over the arranging of the business trip, and the travel expenses shall be considered fully allocable to business activity.

Example 5. E, a managing executive and principal shareholder of X Company, travels from New York to Stockholm, Sweden, to attend a series of business meetings. At the conclusion of the series of meetings, which last 1 week, E spends 1 week on a personal vacation in Stockholm. If E establishes either that he did not have substantial control over the arranging of the trip or that a major consideration in his determining to make the trip was not to provide an opportunity for taking a personal vacation, the entire travel expense to and from Stockholm shall be considered fully allocable to business activity.

Example 6. F, a self-employed professional man, flew from New York to Copenhagen, Denmark, to attend a convention sponsored by a professional society. The trip lasted 3 weeks, of which 2 weeks were spent on vacation in Europe. F generally would be regarded as having substantial control over arranging this business trip. Unless F can establish that obtaining a vacation was not a major consideration in determining to make the trip, the disallowance rules of this section apply.

Example 7. Taxpayer G flew from Chicago to New York where he spent 6 days on business. He then flew to London where he conducted business for 2 days. G then flew to Paris for a 5 day vacation after which he flew back to Chicago, with a scheduled landing in New York for the purpose of adding and discharging passengers. G would not have made the trip except for the business he had to conduct in London. The travel outside the United States away from home, including 2 days for travel en route, exceeded a week and the time devoted to nonbusiness activities was not less than 25 percent of the total time on such travel. The 2 days spent traveling from Chicago to New York and return, and the 6 days spent in New York are disregarded for purposes of determining whether the travel outside the United States away from home exceeded a week and whether the time devoted to nonbusiness activities was less than 25 percent of the total time outside the United States away from home. If G is unable to establish either that he did not have substantial control over the arranging of the business trip or that an opportunity for taking a personal vacation was not a major consideration in his determining to make the trip, 5/9ths (5 days devoted to nonbusiness activities out of a total 9 days outside the United States away from home on the trip) of the expenses attributable to transportation and food from New York to London and from London to New York will be disallowed (unless G establishes that a different method of allocation more clearly reflects the portion of time outside the United States away from home which is attributable to nonbusiness activity).

(h) *Cross reference.* For rules with respect to whether an expense is travel or entertainment, see paragraph (b)(1)(iii) of § 1.274–2.

[T.D. 6758, 29 FR 12768, Sept. 10, 1964]

§ 1.274–5 Substantiation requirements.

(a)–(b) [Reserved]. For further guidance, see § 1.274–5T(a) and (b).

(c) *Rules of substantiation*—(1) [Reserved]. For further guidance, see §1.274–5T(c)(1).

(2) *Substantiation by adequate records*—(i) and (ii) [Reserved]. For further guidance, see §1.274–5T(c)(2)(i) and (ii).

(iii) *Documentary evidence*—(A) Except as provided in paragraph (c)(2)(iii)(B), documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure, is required for—

(*1*) Any expenditure for lodging while traveling away from home, and

(*2*) Any other expenditure of $75 or more except, for transportation charges, documentary evidence will not be required if not readily available.

(B) The Commissioner, in his or her discretion, may prescribe rules waiving the documentary evidence requirements in circumstances where it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, the number of people served, and, if a charge is made for an item other than meals and beverages, an indication that such is the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv)–(v) [Reserved]. For further guidance, see §1.274–5T(c)(2)(iv) and (v).

(3)–(7) [Reserved]. For further guidance, see §1.274–5T(c)(3) through (7).

(d)–(e) [Reserved]. For further guidance, see §1.274–5T(d) and (e).

(f) *Reporting and substantiation of expenses of certain employees for travel, entertainment, gifts, and with respect to listed property*—(1) through (3) [Reserved]. For further guidance, see §1.274–5T(f)(1) through (3).

(4) *Definition of an adequate accounting to the employer*—(i) *In general.* For purposes of this paragraph (f) an *adequate accounting* means the submission to the employer of an account book, diary, log, statement of expense, trip sheet, or similar record maintained by the employee in which the information as to each element of an expenditure or use (described in paragraph (b) of this section) is recorded at or near the time of the expenditure or use, together with supporting documentary evidence, in a manner that conforms to all the adequate records requirements of paragraph (c)(2) of this section. An adequate accounting requires that the employee account for all amounts received from the employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, gifts, and the use of listed property. The methods of substantiation allowed under paragraph (c)(4) or (c)(5) of this section also will be considered to be an adequate accounting if the employer accepts an employee's substantiation and establishes that such substantiation meets the requirements of paragraph (c)(4) or (c)(5). For purposes of an adequate accounting, the method of substantiation allowed under paragraph (c)(3) of this section will not be permitted.

(ii) *Procedures for adequate accounting without documentary evidence.* The Commissioner may, in his or her discretion, prescribe rules under which an employee may make an adequate accounting to an employer by submitting an account book, log, diary, etc., alone, without submitting documentary evidence.

(iii) *Employer.* For purposes of this section, the term *employer* includes an agent of the employer or a third party payor who pays amounts to an employee under a reimbursement or other expense allowance arrangement.

(5) [Reserved]. For further guidance, see § 1.274–5T(f)(5).

(g) *Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances*—(1) *In general.* The Commissioner may, in his or her discretion, prescribe rules in pronouncements of general applicability under which allowances for expenses described in paragraph (g)(2) of this section will, if in accordance with reasonable business practice, be regarded as equivalent to substantiation by adequate records or other sufficient evidence, for purposes of paragraph (c) of this section, of the amount of the expenses and as satisfying, with respect to the amount of the expenses, the requirements of an adequate accounting to the employer for purposes of paragraph (f)(4) of this section. If the total allowance received exceeds the deductible expenses paid or incurred by the employee, such excess must be reported as income on the employee's return. See paragraph (j)(1) of this section relating to the substantiation of meal expenses while traveling away from home, and paragraph (j)(2) of this section relating to the substantiation of expenses for the business use of a vehicle.

(2) *Allowances for expenses described.* An allowance for expenses is described in this paragraph (g)(2) if it is a—

(i) Reimbursement arrangement covering ordinary and necessary expenses of traveling away from home (exclusive of transportation expenses to and from destination);

(ii) Per diem allowance providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination); or

(iii) Mileage allowance providing for ordinary and necessary expenses of local transportation and transportation to, from, and at the destination while traveling away from home.

(h) [Reserved]. For further guidance, see § 1.274–5T(h).

(i) [Reserved]

(j) *Authority for optional methods of computing certain expenses*—(1) *Meal expenses while traveling away from home.* The Commissioner may establish a method under which a taxpayer may use a specified amount or amounts for meals while traveling away from home in lieu of substantiating the actual cost of meals. The taxpayer will not be relieved of the requirement to substantiate the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraphs (b)(2) and (c) of this section.

(2) *Use of mileage rates for vehicle expenses.* The Commissioner may establish a method under which a taxpayer may use mileage rates to determine the amount of the ordinary and necessary expenses of using a vehicle for local transportation and transportation to, from, and at the destination while traveling away from home in lieu of substantiating the actual costs. The method may include appropriate limitations and conditions in order to reflect more accurately vehicle expenses over the entire period of usage. The taxpayer will not be relieved of the requirement to substantiate the amount of each business use (i.e., the business mileage), or the time and business purpose of each use. See paragraphs (b)(2) and (c) of this section.

(3) *Incidental expenses while traveling away from home.* The Commissioner may establish a method under which a taxpayer may use a specified amount or amounts for incidental expenses paid or incurred while traveling away from home in lieu of substantiating the actual cost of incidental expenses. The taxpayer will not be relieved of the requirement to substantiate the actual cost of other travel expenses as well as the time, place, and business purpose of the travel.

(k) *Exceptions for qualified nonpersonal use vehicles*—(1) *In general.* The substantiation requirements of section 274(d) and this section do not apply to any qualified nonpersonal use vehicle (as defined in paragraph (k)(2) of this section).

(2) *Qualified nonpersonal use vehicle*—(i) *In general.* For purposes of section 274(d) and this section, the term *qualified nonpersonal use vehicle* means any vehicle which, by reason of its nature (that is, design), is not likely to be used more than a de minimis amount for personal purposes.

(ii) *List of vehicles.* Vehicles which are qualified nonpersonal use vehicles include the following:

(A) Clearly marked police, fire, and public safety officer vehicles (as defined and to the extent provided in paragraph (k)(3) of this section).

(B) Ambulances used as such or hearses used as such.

(C) Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds.

(D) Bucket trucks (cherry pickers).

(E) Cement mixers.

(F) Combines.

(G) Cranes and derricks.

(H) Delivery trucks with seating only for the driver, or only for the driver plus a folding jump seat.

(I) Dump trucks (including garbage trucks).

(J) Flatbed trucks.

(K) Forklifts.

(L) Passenger buses used as such with a capacity of at least 20 passengers.

(M) Qualified moving vans (as defined in paragraph (k)(4) of this section).

(N) Qualified specialized utility repair trucks (as defined in paragraph (k)(5) of this section).

(O) Refrigerated trucks.

(P) School buses (as defined in section 4221(d)(7)(c)).

(Q) Tractors and other special purpose farm vehicles.

(R) Unmarked vehicles used by law enforcement officers (as defined in paragraph (k)(6) of this section) if the use is officially authorized.

(S) Such other vehicles as the Commissioner may designate.

(3) *Clearly marked police, fire, or public safety officer vehicles.* A police, fire, or public safety officer vehicle is a vehicle, owned or leased by a governmental unit, or any agency or instrumentality thereof, that is required to be used for commuting by a police officer, fire fighter, or public safety officer (as defined in section 402(l)(4)(C) of this chapter) who, when not on a regular shift, is on call at all times, provided that any personal use (other than commuting) of the vehicle outside the limit of the police officer's arrest powers or the fire fighter's or public safety officer's obligation to respond to an emergency is prohibited by such governmental unit. A police, fire, or public safety officer vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police, fire, or public safety officer vehicle. A marking on a license plate is not a clear marking for purposes of this paragraph (k).

(4) *Qualified moving van.* The term *qualified moving van* means any truck or van used by a professional moving company in the trade or business of moving household or business goods if—

(i) No personal use of the van is allowed other than for travel to and from a move site (or for de minimis personal use, such as a stop for lunch on the way between two move sites);

(ii) Personal use for travel to and from a move site is an irregular practice (that is, not more than five times a month on average); and

(iii) Personal use is limited to situations in which it is more convenient to the employer, because of the location of the employee's residence in relation to the location of the move site, for the van not to be returned to the employer's business location.

(5) *Qualified specialized utility repair truck.* The term *qualified specialized utility repair truck* means any truck (not including a van or pickup truck) specifically designed and used to carry heavy tools, testing equipment, or parts if—

(i) The shelves, racks, or other permanent interior construction which has been installed to carry and store such heavy items is such that it is unlikely that the truck will be used more than a de minimis amount for personal purposes; and

(ii) The employer requires the employee to drive the truck home in order to be able to respond in emergency situations for purposes of restoring or maintaining electricity, gas, telephone, water, sewer, or steam utility services.

(6) *Unmarked law enforcement vehicles*—(i) *In general.* The substantiation requirements of section 274(d) and this section do not apply to officially authorized uses of an unmarked vehicle by a "law enforcement officer". To qualify for this exception, any personal use must be authorized by the Federal, State, county, or local governmental

agency or department that owns or leases the vehicle and employs the officer, and must be incident to law-enforcement functions, such as being able to report directly from home to a stakeout or surveillance site, or to an emergency situation. Use of an unmarked vehicle for vacation or recreation trips cannot qualify as an authorized use.

(ii) *Law enforcement officer.* The term *law enforcement officer* means an individual who is employed on a full-time basis by a governmental unit that is responsible for the prevention or investigation of crime involving injury to persons or property (including apprehension or detention of persons for such crimes), who is authorized by law to carry firearms, execute search warrants, and to make arrests (other than merely a citizen's arrest), and who regularly carries firearms (except when it is not possible to do so because of the requirements of undercover work). The term ''law enforcement officer'' may include an arson investigator if the investigator otherwise meets the requirements of this paragraph (k)(6)(ii), but does not include Internal Revenue Service special agents.

(7) *Trucks and vans.* The substantiation requirements of section 274(d) and this section apply generally to any pickup truck or van, unless the truck or van has been specially modified with the result that it is not likely to be used more than a de minimis amount for personal purposes. For example, a van that has only a front bench for seating, in which permanent shelving that fills most of the cargo area has been installed, that constantly carries merchandise or equipment, and that has been specially painted with advertising or the company's name, is a vehicle not likely to be used more than a de minimis amount for personal purposes.

(8) *Examples.* The following examples illustrate the provisions of paragraph (k)(3) and (6) of this section:

Example 1. Detective C, who is a ''law enforcement officer'' employed by a state police department, headquartered in City M, is provided with an unmarked vehicle (equipped with radio communication) for use during off-duty hours because C must be able to communicate with headquarters and be available for duty at any time (for example, to report to a surveillance or crime site). The police department generally has officially authorized personal use of the vehicle by C but has prohibited use of the vehicle for recreational purposes or for personal purposes outside the state. Thus, C's use of the vehicle for commuting between headquarters or a surveillance site and home and for personal errands is authorized personal use as described in paragraph (k)(6)(i) of this section. With respect to these authorized uses the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not included in C's gross income.

Example 2. Detective T is a ''law enforcement officer'' employed by City M. T is authorized to make arrests only within M's city limits. T, along with all other officers of the force, is ordinarily on duty for eight hours each work day and on call during the other sixteen hours. T is provided with the use of a clearly marked police vehicle in which T is required to commute to his home in City M. The police department's official policy regarding marked police vehicles prohibits its personal use (other than commuting) of the vehicles outside the city limits. When not using the vehicle on the job, T uses the vehicle only for commuting, personal errands on the way between work and home, and personal errands within City M. All use of the vehicle by T conforms to the requirements of paragraph (k)(3) of this section. Therefore, the value of that use is excluded from T's gross income as a working condition fringe and the vehicle is not subject to the substantiation requirements of section 274(d).

Example 3. Director C is employed by City M as the director of the City's rescue squad and is provided with a vehicle for use in responding to emergencies. Director C is trained in rescue activity and has the legal authority and legal responsibility to engage in rescue activity. The city's rescue squad is not a part of City M's police or fire departments. The director's vehicle is a sedan which is painted with insignia and words identifying the vehicle as being owned by the City's rescue squad. C, when not on a regular shift, is on call at all times. The City's official policy regarding clearly marked public safety officer vehicles prohibits personal use (other than for commuting) of the vehicle outside of the limits of the public safety officer's obligation to respond to an emergency. When not using the vehicle to respond to emergencies, City M authorizes C to use the vehicle only for commuting, personal errands on the way between work and home, and personal errands within the limits of C's obligation to respond to emergencies. With respect to these authorized uses, the vehicle is not subject to the substantiation requirements of section 274(d) and the value of these uses is not includable in C's gross income.

Example 4. Coroner D is employed by County N to investigate and determine the cause, time, and manner of certain deaths occurring in the County. Coroner D also safeguards the property of the deceased, notifies the next of kin, conducts inquests, and arranges for the burial of indigent persons. D is provided with a vehicle for use by County N. The vehicle is to be used in County N business and for commuting. Personal use other than for commuting purposes is forbidden. D is trained in rescue activity but has no legal authority or legal responsibility to engage in rescue activity. D's vehicle is a sedan which is painted with insignia and words identifying it as a County N vehicle. D, when not on a regular shift, is on call at all times. D does not satisfy the criteria of a public safety officer under 28 CFR 32.3 (2008). Thus, D's vehicle cannot qualify as a clearly marked public safety officer vehicle. Accordingly, business use of the vehicle is subject to the substantiation requirements of section 274(d), and the value of any personal use of the vehicle, such as commuting, is includable in D's gross income.

(l) *Definitions.* For purposes of section 274(d) and this section, the terms *automobile* and *vehicle* have the same meanings as prescribed in §1.61–21(d)(1)(ii) and (e)(2), respectively. Also, for purposes of section 274(d) and this section, the terms *employer, employee* and *personal use* have the same meanings as prescribed in §1.274–6T(e).

(m) *Effective date.* This section applies to expenses paid or incurred after December 31, 1997. However, paragraph (j)(3) of this section applies to expenses paid or incurred after September 30, 2002, and paragraph (k) applies to clearly marked public safety officer vehicles, as defined in §1.274–5(k)(3), only with respect to uses occurring after May 19, 2010.

[T.D. 8864, 65 FR 4122, Jan. 26, 2000; 65 FR 15547, Mar. 23, 2000, as amended by T.D. 9020, 67 FR 68513, Nov. 12, 2002; T.D. 9064, 68 FR 39011, July 1, 2003; T.D. 9483, 75 FR 27936, May 19, 2010]

§ 1.274–5T Substantiation requirements (temporary).

(a) *In general.* For taxable years beginning on or after January 1, 1986, no deduction or credit shall be allowed with respect to—

(1) Traveling away from home (including meals and lodging),

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e),

(3) Gifts defined in section 274(b), or

(4) Any listed property (as defined in section 280F(d)(4) and §1.280F–6T(b)), unless the taxpayer substantiates each element of the expenditure or use (as described in paragraph (b) of this section) in the manner provided in paragraph (c) of this section. This limitation supersedes the doctrine found in *Cohan v. Commissioner,* 39 F. 2d 540 (2d Cir. 1930). The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expenses but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction or credit shall be allowed a taxpayer on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term *entertainment* means entertainment, amusement, or recreation, and use of a facility therefor; and the term *expenditure* includes expenses and items (including items such as losses and depreciation).

(b) *Elements of an expenditure or use*—(1) *In general.* Section 274(d) and this section contemplate that no deduction or credit shall be allowed for travel, entertainment, a gift, or with respect to listed property unless the taxpayer substantiates the requisite elements of each expenditure or use as set forth in this paragraph (b).

(2) *Travel away from home.* The elements to be provided with respect to an expenditure for travel away from home are—

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) *Time.* Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) *Place.* Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) *Business purpose.* Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) *Entertainment in general.* The elements to be proved with respect to an expenditure for entertainment are—

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) *Time.* Date of entertainment;

(iii) *Place.* Name, if any, address or location, and destination of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) *Business purpose.* Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) *Business relationship.* Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(4) *Entertainment directly preceding or following a substantial and bona fide business discussion.* If a taxpayer claims a deduction for entertainment directly preceding or following a substantial and bona fide business discussion on the ground that such entertainment was associated with the active conduct of the taxpayer's trade or business, the elements to be proved with respect to such expenditure, in addition to those enumerated in paragraph (b)(3) (i), (ii), (iii), and (v) of this section are—

(i) *Time.* Date and duration of business discussion;

(ii) *Place.* Place of business discussion;

(iii) *Business purpose.* Nature of business discussion, and business reason for the entertainment or nature of business benefit derived or expected to be derived as the result of the entertainment.

(iv) *Business relationship.* Identification of those persons entertained who participated in the business discussion.

(5) *Gifts.* The elements to be proved with respect to an expenditure for a gift are—

(i) *Amount.* Cost of the gift to the taxpayer;

(ii) *Time.* Date of the gift;

(iii) *Description.* Description of the gift;

(iv) *Business purpose.* Business reason for the gift or nature of business benefit derived or expected to be derived as a result of the gift; and

(v) *Business relationship.* Occupation or other information relating to the recipient of the gift, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(6) *Listed property.* The elements to be proved with respect to any listed property are—

(i) *Amount*—(A) *Expenditures.* The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, the cost of capital improvements, lease payments, the cost of maintenance and repairs, or other expenditures, and

(B) *Uses.* The amount of each business/investment use (as defined in §1.280F–6T (d)(3) and (e)), based on the appropriate measure (i.e., mileage for automobiles and other means of transportation and time for other listed property, unless the Commissioner approves an alternative method), and the total use of the listed property for the taxable period.

(ii) *Time.* Date of the expenditure or use with respect to listed property, and

(iii) *Business or investment purpose.* The business purpose for an expenditure or use with respect to any listed property (see §1.274–5T(c)(6)(i) (B) and (C) for special rules for the aggregation of expenditures and business use and §1.280F–6T(d)(2) for the distinction between qualified business use and business/investment use).

See also §1.274–5T(e) relating to the substantiation of business use of employer-provided listed property and §1.274–6T for special rules for substantiating the business/investment use of certain types of listed property.

(c) *Rules of substantiation*—(1) *In general.* Except as otherwise provided in this section and §1.274–6T, a taxpayer must substantiate each element of an expenditure or use (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute proof of each expenditure or use referred to in section 274. Written evidence has considerably more probative value than oral evidence alone. In addition, the probative value of written evidence is greater the closer in time it relates to the expenditure or use. A contemporaneous log is not required, but a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not make at or near the time of the expenditure or use must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in paragraph (c)(2) of this section.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the ''adequate records'' requirements of section 274(d), a taxpayer shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record (as provided in paragraph (c)(2)(ii) of this section), and documentary evidence (as provided in paragraph (c)(2)(iii) of this section) which, in combination, are sufficient to establish each element of an expenditure or use specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, log, statement of expense, trip sheet, or similar record which duplicates information reflected on a receipt so long as the account book, etc. and receipt complement each other in an orderly manner.

(ii) *Account book, diary, etc.* An account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use.

(A) *Made at or near the time of the expenditure or use.* For purposes of this section, the phrase *made at or near the time of the expenditure or use* means the element of an expenditure or use are recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use, such as the amount, time, place, and business purpose of the expenditure and business relationship. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained in accordance with the provisions of this paragraph (c)(2)(ii) shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, shall be considered a record made at or near the time of such use.

(B) *Substantiation of business purpose.* In order to constitute an adequate record of business purpose within the meaning of section 274(d) and this paragraph (c)(2), a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

(C) *Substantiation of business use of listed property*—(*1*) *Degree of substantiation.* In order to constitute an adequate record (within the meaning of section 274(d) and this paragraph (c)(2)(ii)), which substantiates business/investment use of listed property (as defined in §1.280F–6T(d)(3)), the record must contain sufficient information as to each element of every business/investment use. However, the level of detail required in an adequate record to substantiate business/investment use may vary depending upon the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of a truck is to make deliveries to customers on an established route may satisfy the adequate record requirement by recording the total number miles driven during the taxable year, the length of the delivery route once, and the date of each trip at or near the time of the trips. Alternatively, the taxpayer may establish the date of each trip with a receipt, record of delivery, or other documentary evidence.

(*2*) *Written record.* Generally, an adequate record must be written. However, a record of the business use of listed property, such as a computer or automobile, prepared in a computer memory device with the aid of a logging program will constitute an adequate record.

(D) *Confidential information.* If any information relating to the elements of an expenditure or use, such as place, business purpose, or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, log, statement of expense, trip sheet, or similar record, provided such information is recorded at or near the time of the expenditure or use and is elsewhere available to the district director to substantiate such element of the expenditure or use.

(iii) [Reserved]. For further guidance, see §1.274–5(c)(2)(iii).

(iv) *Retention of written evidence.* The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of the adequate records and documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (f)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (f)(5) of this section.

(v) *Substantial compliance.* If a taxpayer has not fully substantiated a particular element of an expenditure or use, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the ''adequate records'' requirements of this paragraph (c)(2) with respect to the expenditure or use, the taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) *Substantiation by other sufficient evidence*—(i) *In general.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the ''adequate records'' requirements of paragraph (c)(2) of this section with respect to an element of an expenditure or use, then, except as otherwise provided in this paragraph, the taxpayer must establish such element—

(A) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(B) By other corroborative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost or amount, time, place, or date of an expenditure or use, the corrobative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witnesses setting forth detailed information about such element, or the documentary evidence described in paragraph (c)(2) of this section. If such element is either the business relationship to the taxpayer of persons entertained, or the business purpose of an expenditure, the corrobative evidence may be circumstantial evidence.

(ii) *Sampling*—(A) *In general.* Except as provided in paragraph (c)(3)(ii)(B) of this section, a taxpayer may maintain an adequate record for portions of a taxable year and use that record to substantiate the business/investment use of listed property for all or a portion of the taxable year if the taxpayer can demonstrate by other evidence that the periods for which an adequate record is maintained are representative of the use for the taxable year or a portion thereof.

(B) *Exception for pooled vehicles.* The sampling method of paragraph (c)(3)(ii)(A) of this section may not be used to substantiate the business/investment use of an automobile or other vehicle of an employer that is made available for use by more than one employee for all or a portion of a taxable year.

(C) *Examples.* The following examples illustrate this paragraph (c)(3)(ii).

Example 1. A, a sole proprietor and calendar year taxpayer, operates an interior decorating business out of her home. A uses an automobile for local business travel to visit the homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients when feasible. There is no other business use of the automobile but A and other members of her family also use the automobile for personal purposes. A maintains adequate records for the first three months of 1986 that indicate that 75 percent of the use of the automobile was in A's business. Invoices from subcontractors and paid bills indicate that A's business continued at approximately the same rate for the remainder of 1986. If other circumstances do not change (e.g., A does not obtain a second car for exclusive use in her business), the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 2. The facts are the same as in *Example 1,* except that A maintains adequate records during the first week of every month, which indicate that 75 percent of the use of the automobile is in A's business. The invoices from A's business indicate that A's business continued at the same rate during the subsequent weeks of each month so that A's weekly records are representative of each month's business use of the automobile. Thus, the determination that the business/investment use of the automobile for the taxable year is 75 percent is based on sufficient corroborative evidence.

Example 3. B, a sole proprietor and calendar year taxpayer, is a salesman in a large metropolitan area for a company that manufactures household products. For the first three weeks of each month, B uses his own automobile occasionally to travel within the metropolitan area on business. During these three weeks, B's use of the automobile for business purposes does not follow a consistent pattern from day to day or week to week. During the fourth week of each month, B delivers to his customers all the orders taken during the previous month. B's use of his automobile for business purposes, as substantiated by adequate records, is 70 percent of the total use during that fourth week. In this example, a determination based on the records maintained during that fourth week that the business/investment use of the automobile for the taxable year is 70 percent is not based on sufficient corroborative evidence because use during this week is not representative of use during other periods.

(iii) *Special rules.* See §1.274–6T for special rules for substantiation by sufficient corroborating evidence with respect to certain listed property.

(4) *Substantiation in exceptional circumstances.* If a taxpayer establishes that, by reason of the inherent nature of the situation—

(i) He was unable to obtain evidence with respect to an element of the expenditure or use which conforms fully to the "adequate records" requirements of paragraph (c)(2) of this section,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the "other sufficient evidence" requirements of paragraph (c)(3) of this section, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) *Loss of records due to circumstances beyond control of the taxpayer.* Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire, flood,

earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures or use.

(6) *Special rules*—(i) *Separate expenditure or use*—(A) *In general.* For the purposes of this section, each separate payment or use by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses or uses may be substantiated as a single item. To illustrate the above rules, where a taxpayer entertains a business guest at dinner and thereafter at the theater, the payment for dinner shall be considered to constitute one expenditure and the payment for the tickets for the theater shall be considered to constitute a separate expenditure. Similarly, if during a day of business travel a taxpayer makes separate payments for breakfast, lunch, and dinner, he shall be considered to have made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each serving of refreshments, the total amount expended for the refreshments will be treated as a single expenditure. A tip may be treated as a separate expenditure.

(B) *Aggregation of expenditures.* Except as otherwise provided in this section, the account book, diary, log, statement of expense, trip sheet, or similar record required by paragraph (c)(2)(ii) of this section shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. In addition, amounts expended in connection with the use of listed property during a taxable year, such as for gasoline or repairs for an automobile, may be aggregated. If these expenses are aggregated, the taxpayer must establish the date and amount, but need not prove the business purpose of each expenditure. Instead, the taxpayer may prorate the expenses based on the total business use of the listed property. For other provisions permitting recording of aggregate amounts in an account book, diary, log, statement of expense, trip sheet, or similar record, see paragraphs (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

(C) *Aggregation of business use.* Uses which may be considered part of a single use, for example, a round trip or uninterrupted business use, may be accounted for by a single record. For example, use of a truck to make deliveries at several different locations which begins and ends at the business premises and which may include a stop at the business premises in between two deliveries may be accounted for by a single record of miles driven. In addition, use of a passenger automobile by a salesman for a business trip away from home over a period of time may be accounted for by a single record of miles traveled. De minimis personal use (such as a stop for lunch on the way between two business stops) is not an interruption of business use.

(ii) *Allocation of expenditure.* For purposes of this section, if a taxpayer has established the amount of an expenditure, but is unable to establish the portion of such amount which is attributable to each person participating in the event giving rise to the expenditure, such amount shall ordinarily be allocated to each participant on a pro rata basis, if such determination is material. Accordingly, the total number of persons for whom a travel or entertainment expenditure is incurred must be established in order to compute the portion of the expenditure allocable to such person.

(iii) *Primary use of a facility.* Section 274(a) (1)(B) and (2)(C) deny a deduction for any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of the taxpayer's trade or business. A determination whether a facility before January 1, 1979, or a club before January 1, 1994, was used primarily for the furtherance of the taxpayer's trade or business will depend upon the facts and circumstances of each case. In order to establish that a facility was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain—

(A) For each use of the facility claimed to be in furtherance of the taxpayer's trade or business, the elements of an expenditure specified in paragraph (b)(3) of this section, and

(B) For each use of the facility not in furtherance of the taxpayer's trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as ''personal use'' or ''family use'' would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

(iv) *Additional information.* In a case where it is necessary to obtain additional information, either—

(A) To clarify information contained in records, statements, testimony, or documentary evidence submitted by a taxpayer under the provisions of paragraph (c)(2) or (c)(3) of this section, or

(B) To establish the reliability or accuracy of such records, statements, testimony, or documentary evidence, the district director may, notwithstanding any other provision of this section, obtain such additional information by personal interview or otherwise as he determines necessary to implement properly the provisions of section 274 and the regulations thereunder.

(7) *Specific exceptions.* Except as otherwise prescribed by the Commissioner, substantiation otherwise required by this paragraph is not required for—

(i) Expenses described in section 274(e)(2) relating to food and beverages for employees, section 274(e)(3) relating to expenses treated as compensation, section 274(e)(8) relating to items available to the public, and section 274(e)(9) relating to entertainment sold to customers, and

(ii) Expenses described in section 274(e)(5) relating to recreational, etc., expenses for employees, except that a taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees.

(d) *Disclosure on returns*—(1) *In general.* The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction or credit for entertainment, gifts, travel, or with respect to listed property, or any other person receiving advances, reimbursements, or allowances for such items, shall make disclosure on his tax return with respect to such items. The provisions of this paragraph shall apply notwithstanding the provisions of paragraph (f) of this section.

(2) *Business use of passenger automobiles and other vehicles.* (i) On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any vehicle are required to answer certain questions providing information about the use of the vehicle. The information required on the tax return relates to mileage (total, business, commuting, and other personal mileage), percentage of business use, date placed in service, use of other vehicles, after-work use, whether the taxpayer has evidence to support the business use claimed on the return, and whether or not the evidence is written.

(ii) Any employer that provides the use of a vehicle to an employee must obtain information from the employee sufficient to complete the employer's tax return. Any employer that provides more than five vehicles to its employees need not include any information on its return. The employer, instead, must obtain the information from its employees, indicate on its return that it has obtained the information, and retain the information received. Any employer—

(A) That can satisfy the requirements of § 1.274–6T(a)(2), relating to vehicles not used for personal purposes,

(B) That can satisfy the requirements of § 1.274–6T(a)(3), relating to vehicles not used for personal purposes other than commuting, or

(C) That treats all use of vehicles by employees as personal use need not obtain information with respect to those vechicles, but instead must indicate on its return that it has vehicles exempt from the requirements of this paragraph (d)(2).

(3) *Business use of other listed property.* On returns for taxable years beginning after December 31, 1984, taxpayers that claim a deduction or credit with respect to any listed property other than a vehicle (for example, a yacht, airplane, or certain computers) are required to provide the following information:

(i) The date that the property was placed in service,

(ii) The percentage of business use,

(iii) Whether evidence is available to support the percentage of business use claimed on the return, and

(iv) Whether the evidence is written.

(e) *Substantiation of the business use of listed property made available by an employer for use by an employee*—(1) *Employee*—(i) *In general.* An employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the requirements of section 274(d) and either this section or § 1.274–6T.

(ii) *Vehicles treated as used entirely for personal purposes.* If an employer includes the value of the availability of a vehicle (as defined in § 1.61–21(e)(2)) in an employee's gross income without taking into account any exclusion for a working condition fringe allowable under section 132 and the regulations thereunder with respect to the vehicle, the employee must substantiate any deduction claimed under §§ 1.162–25 and 1.162–25T for the business/investment use of the vehicle in accordance with the requirements of section 274(d) and either this section or § 1.274–6T.

(2) *Employer*—(i) *In general.* An employer substantiates its business/investment use of listed property by showing either—

(A) That, based on evidence that satisfies the requirements of section 274(d) or statements submitted by employees that summarize such evidence, all or a portion of the use of the listed property is by employees in the employer's trade or business and, if any employee used the property for personal purposes, the employer included an appropriate amount in the employee's income, or

(B) In the case of a vehicle, the employer treats all use by employees as personal use and includes an appropriate amount in the employees' income.

(ii) *Reliance on employee records.* For purposes of substantiating the business/investment use of listed property that an employer provides to an employee and for purposes of the information required by paragraph (d)(2) and (3) of this section, the employer may rely on adequate records maintained by the employee or on the employee's own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate. The employer must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, the employer may rely on a statement submitted by the employee that provides sufficient information to allow the employer to determine the business/investment use of the property unless the employer knows or has reason to know that the statement is not based on adequate records or on the employee's own statement corroborated by other sufficient evidence. If the employer relies on the employee's statement, the employer must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence.

(f) *Reporting and substantiation of expenses of certain employees for travel, entertainment, gifts, and with respect to listed property*—(1) *In general.* The purpose of this paragraph is to provide rules for reporting and substantiation of certain expenses paid or incurred by employees in connection with the performance of services as employees. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 262, 274(c), and 280F. Thus, the term *business expenses* does not include personal, living, or family expenses disallowed by section 262, travel expenses disallowed by section 274(c), or cost recovery deductions and credits with respect to listed property disallowed by section 280F(d)(3) because the use of such property is not for the convenience of the employer and required as a condition of employment. Except as provided in paragraph (f)(2), advances, reimbursements, or allowances for such expenditures must be reported as income by the employee.

(2) *Reporting of expenses for which the employee is required to make an adequate accounting to his employer*—(i) *Reimbursements equal to expenses.* For purposes of computing tax liability, an employee need not report on his tax return business expenses for travel, transportation, entertainment, gifts, or with respect to listed property, paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer (as defined in paragraph (f)(4) of this section) and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses.

(ii) *Reimbursements in excess of expenses.* In case the total of the amounts charged directly or indirectly to the employer or received from the employer as advances, reimbursements, or otherwise, exceeds the business expenses paid or incurred by the employee and the employee is required to, and does, make an adequate accounting to his employer for such expenses, the employee must include such excess (including amounts received for expenditures not deductible by him) in income.

(iii) *Expenses in excess of reimbursements.* If an employee incurs deductible business expenses on behalf of his employer which exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee makes an adequate accounting to his employer, the employee must be able to substantiate any deduction for such excess with such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(3) *Reporting of expenses for which the employee is not required to make an adequate accounting to his employer.* If the employee is not required to make an adequate accounting to his employer for his business expenses or, though required, fails to make an adequate accounting for such expenses, he must submit, as a part of his tax return, the appropriate form issued by the Internal Revenue Service for claiming deductions for employee business expenses (e.g., Form 2106, Employee Business Expenses, for 1985) and provide the information requested on that form, including the information required by paragraph (d)(2) and (3) of this section if the employee's business expenses are with respect to the use of listed property. In addition, the employee must maintain such records and supporting evidence as will substantiate each element of an expenditure or use (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(4) [Reserved]. For further guidance, see §1.274–5(f)(4).

(5) *Substantiation of expenditures by certain employees.* An employee who makes an adequate accounting to his employer within the meaning of this paragraph will not again be required to

substantiate such expense account information except in the following cases:

(i) An employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess,

(ii) An employee who is related to his employer within the meaning of section 267(b), but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent, and

(iii) Employees in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or where it cannot be determined that such procedures are adequate. The district director will determine whether the employer's accounting procedures are adequate by considering the facts and circumstances of each case, including the use of proper internal controls. For example, an employer should require that an expense account be verified and approved by a reasonable person other than the person incurring such expenses. Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from his employees as defined in paragraph (f)(4) of this section, or does not maintain such substantiation. To the extent an employer fails to maintain adequate accounting procedures he will thereby obligate his employees to substantiate separately their expense account information.

(g) [Reserved]. For further guidance, see §1.274–5(g).

(h) *Reporting and substantiation of certain reimbursements of persons other than employees*—(1) *In general.* The purpose of this paragraph is to provide rules for the reporting and substantiation of certain expenses for travel, entertainment, gifts, or with respect to listed property paid or incurred by one person (hereinafter termed ''independent contractor'') in connection with services performed for another person other than an employer (hereinafter termed ''client or customer'') under a reimbursement or other expense allowance arrangement with such client or customer. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, gifts, or with respect to listed property which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by sections 262 and 274(c). Thus, the term *business expenses* does not include personal, living, or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and reimbursements for such expenditures must be reported as income by the independent contractor. For purposes of this paragraph, the term *reimbursements* means advances, allowances, or reimbursements received by an independent contractor for travel, entertainment, gifts, or with respect to listed property in connection with the performance by him of services for his client or customer, under a reimbursement or other expense allowance arrangement with his client or customer, and includes amounts charged directly or indirectly to the client or customer through credit card systems or otherwise. See paragraph (j) of this section relating to the substantiation of meal expenses while traveling away from home.

(2) *Substantiation by independent contractors.* An independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure (described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income. An independent contractor shall so substantiate a reimbursement for entertainment regardless of whether he accounts (within the meaning of paragraph (h)(3) of this section) for such entertainment.

(3) *Accounting to a client or customer under section 274(e)(4)(B).* Section 274(e)(4)(B) provides that section 274(a) (relating to disallowance of expenses for entertainment) shall not apply to expenditures for entertainment for which an independent contractor has been reimbursed if the independent contractor accounts to his client or customer, to the extent provided by section 274(d). For purposes of section 274(e)(4)(B), an independent contractor

shall be considered to account to his client or customer for an expense paid or incurred under a reimbursement or other expense allowance arrangement with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) *Substantiation by client or customer.* A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and paragraph (h)(3) of this section) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(i) [Reserved]

(j) [Reserved]. For further guidance, *see* §1.274–5(j).

(k) and (l) [Reserved] For further guidance, see §1.274–5(k) and (l).

(m) *Effective date.* Section 274(d), as amended by the Tax Reform Act of 1984 and Public Law 99–44, and this section (except as provided in paragraph (d)(2) and (3) of this section) apply with respect to taxable years beginning after December 31, 1985. Section 274(d) and this section apply to any deduction or credit claimed in a taxable year beginning after December 31, 1985, with respect to any listed property, regardless of the taxable year in which the property was placed in service. However, except as provided in §1.132–5(h) with respect to qualified nonpersonal use vehicles, the substantiation requirements of section 274(d) and this section do not apply to the determination of an employee's working condition fringe exclusion or to the determination under §1.162–25(b) of an employee's deduction before the date that those requirements apply, under this paragraph (m), to the employer, if the employer is taxable. Paragraph (j)(3) of this section applies to expenses paid or incurred after September 30, 2002.

[T.D. 8061, 50 FR 46014, Nov. 6, 1985, as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985; T.D. 8276, 54 FR 51027, Dec. 12, 1989; T.D. 8451, 57 FR 57669, Dec. 7, 1992; T.D. 8601, 60 FR 36995, July 19, 1995; T.D. 8715, 62 FR 13990, Mar. 25, 1997; T.D. 8864, 65 FR 4123, Jan. 26, 2000; T.D. 9020, 67 FR 68513, Nov. 12, 2002; T.D. 9020, 67 FR 72273, Dec. 4, 2002; T.D. 9064, July 1, 2003; T.D. 9483, 75 FR 27937, May 19, 2010]

§1.274–6 Expenditures deductible without regard to trade or business or other income producing activity.

The provisions of §§1.274–1 through 1.274–5, inclusive, do not apply to any deduction allowable to the taxpayer without regard to its connection with the taxpayer's trade or business or other income producing activity. Examples of such items are interest, taxes such as real property taxes, and casualty losses. Thus, if a taxpayer owned a fishing camp, the taxpayer could still deduct mortgage interest and real property taxes in full even if deductions for its use are not allowable under section 274(a) and §1.274–2. In the case of a taxpayer which is not an individual, the provisions of this section shall be applied as if it were an individual. Thus, if a corporation sustains a casualty loss on an entertainment facility used in its trade or business, it could deduct the loss even though deductions for the use of the facility are not allowable.

[T.D. 8051, 50 FR 36576, Sept. 9, 1985]

§1.274–6T Substantiation with respect to certain types of listed property for taxable years beginning after 1985 (temporary).

(a) *Written policy statements as to vehicles*—(1) *In general.* Two types of written policy statements satisfying the conditions described in paragraph (a)(2) and (3) of this section, if initiated and kept by an employer to implement a policy of no personal use, or no personal use except for commuting, of a vehicle provided by the employer, qualify as sufficient evidence corroborating the taxpayer's own statement and therefore will satisfy the employer's substantiation requirements under section 274(d). Therefore, the employee need not keep a separate set of records for purposes of the employer's substantiation requirements under section 274(d) with respect to use of a vehicle satisfying these written policy statement rules. A written policy statement adopted by a governmental unit as to employee use of its vehicles is eligible for these exceptions to the section 274(d) substantiation rules. Thus, a resolution of a city council or a provision of state law or a state constitution would qualify as a written policy statement, as long as the conditions described in paragraph (a)(2) and (3) of this section are met.

(2) *Vehicles not used for personal purposes*—(i) *Employers.* A policy statement that prohibits personal use by an employee satisfies an employer's substantiation requirements under section 274(d) if all the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business,

(B) When the vehicle is not used in the employer's trade or business, it is kept on the employer's business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer's business premises,

(D) Under a written policy of the employer, neither an employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) The employer reasonably believes that, except for de minimis use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(ii) *Employees.* An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under §1.274–5T, may treat all use of the vehicle as business/investment use if the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business,

(B) When the vehicle is not used in the employer's trade or business, it is kept on the employer's business premises, unless it is temporarily located elsewhere, for example, for maintenance or because of a mechanical failure,

(C) No employee using the vehicle lives at the employer's business premises,

(D) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, except for de minimis personal use (such as a stop for lunch between two business deliveries), and

(E) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose.

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle meets the preceding five conditions.

(3) *Vehicles not used for personal purposes other than commuting*—(i) *Employers.* A policy statement that prohibits personal use by an employee, other than commuting, satisfies an employer's substantiation requirements under section 274(d) if all the following conditions are met—

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) The employer has established a written policy under which neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),

(D) The employer reasonably believes that, except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–21(f)(5) and (6)) required to use an automobile (as defined in §1.61–21(d)(1)(ii)), and

(F) The employer accounts for the commuting use by including in the employee's gross income the commuting value provided in §1.61–21(f)(3) (to the extent not reimbursed by the employee).

There must be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(ii) *Employees.* An employee, in lieu of substantiating the business/investment use of an employer-provided vehicle under §1.274–5T, may substantiate any exclusion allowed under section 132 for a working condition fringe by including in income the commuting value of the vehicle (determined by the employer pursuant to §1.61–21(f)(3)) if all the following conditions are met:

(A) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business,

(B) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(C) Under a written policy of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),

(D) Except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting,

(E) The employee required to use the vehicle for commuting is not a control employee (as defined in §1.61–21(f)(5) and (6) required to use an automobile (as defined in §1.61–21(d)(1)(ii)), and

(F) The employee includes in gross income the commuting value determined by the employer as provided in §1.61–21(f)(3)(to the extent that the employee does not reimburse the employer for the commuting use).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

(b) *Vehicles used in connection with the business of farming*—(1) *In general.* If, during a taxable year or shorter period, a vehicle, not otherwise described in section 274(i), §1.274–5T(k), or paragraph (a) (2) or (3) of this section, is owned or leased by an employer and used during most of a normal business day directly in connection with the business of farming (as defined in paragraph (b)(2) of this section), the employer, in lieu of substantiating the use of the vehicle as prescribed in §1.274–5T(b)(6)(i)(B), may determine any deduction or credit with respect to the vehicle as if the business/investment use (as defined in §1.280F–6T(d)(3)(i)) and the qualified business use (as defined in §1.280F–6T(d)(2)) of the vehicle in the business of farming for the taxable year or shorter period were 75 percent plus that percentage, if any, attributable to an amount included in an employee's gross income. If the vehicle is also available for personal use by employees, the employer must include the value of that personal use in the gross income of the employees, allocated among them in the manner prescribed in §1.132–5(g).

(2) *Directly in connection with the business of farming.* The phrase *directly in connection with the business of farming* means that the vehicle must be used directly in connection with the business of operating a farm (i.e., cultivating land or raising or harvesting any agricultural or horticultural commodity, or the raising, shearing, feeding, caring for, training, and management of animals) or incidental thereto (for example, trips to the feed and supply store).

(3) *Substantiation by employees.* If an employee is provided with the use of a vehicle to which this paragraph (b) applies, the employee may, in lieu of substantiating the business/investment use of the vehicle in the manner prescribed in §1.274–5T, substantiate any exclusion allowed under section 132 for a working condition fringe as if the business/investment use of the vehicle were 75 percent, plus that percentage, if any, determined by the employer to be attributable to the use of the vehicle by individuals other than the employee, provided that the employee includes in gross income the amount determined by the employer as includible in the employee's gross income. *See* §1.132–5(g)(3) for examples illustrating the allocation of use of a vehicle among employees.

(c) *Vehicles treated as used entirely for personal purposes.* An employer may satisfy the substantiation requirements under section 274(d) for a taxable year or shorter period with respect to the business use of a vehicle that is provided to an employee by including the value of the availability of the vehicle during the relevant period in the employee's gross income without any exclusion for a working condition fringe with respect to the vehicle and, if required, by withholding any taxes. Under these circumstances, the employer's business/investment use of the vehicle during the relevant period is 100 percent. The employer's qualified business use of the vehicle is dependent upon the relationship of the employee to the employer (*see* §1.280F–6T(d)(2)).

(d) *Limitation.* If a taxpayer chooses to satisfy the substantiation requirements of section 274(d) and §1.274–5T by using one of the methods prescribed in paragraphs (a) (2) or (3), (b), or (c) of this section and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use another of these methods. Similarly, if a taxpayer chooses to satisfy the substantiation requirements of section 274(d) in the manner prescribed in §1.274–5T and files a return with the Internal Revenue Service for a taxable year consistent with such choice, the taxpayer may not later use a method prescribed in paragraph (a) (2) or (3), (b), or (c) of this section. This rule applies to an employee for purposes of substantiating any working condition fringe exclusion as well as to an employer. For example, if an employee excludes on his federal income tax return for a taxable year 90 percent of the value of the availability of an employer-provided automobile on the basis of records that allegedly satisfy the "adequate records" requirement of §1.274–5T(c)(2), and that requirement is not satisfied, then the employee may not satisfy the substantiation requirements of section 274(d) for the taxable year by any method prescribed in this section, but may present other corroborative evidence as prescribed in §1.274–5T(c)(3).

(e) *Definitions*—(1) *In general.* The definitions provided in this paragraph (e) apply for purposes of section 274(d), §1.274–5T, and this section.

(2) *Employer and employee.* The terms *employer* and *employee* include the following:

(i) A sole proprietor shall be treated as both an employer and employee,

(ii) A partnership shall be treated as an employer of its partners, and

(iii) A partner shall be treated as an employee of the partnership.

(3) *Automobile.* The term *automobile* has the same meaning as prescribed in §1.61–21(d)(1)(ii).

(4) *Vehicle.* The term *vehicle* has the same meaning as prescribed in §1.61–21(e)(2).

(5) *Personal use. Personal use* by an employee of an employer-provided vehicle includes use in any trade or business other than the trade or business of being the employee of the employer providing the vehicle.

(f) *Effective date.* This section is effective for taxable years beginning after December 31, 1985.

[T.D. 8061, 50 FR 46037, Nov. 6, 1985, as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985; T.D. 9849, 84 FR 9233, Mar. 14, 2019]

§ 1.274–7 Treatment of certain expenditures with respect to entertainment-type facilities.

If deductions are disallowed under §1.274–2 with respect to any portion of a facility, such portion shall be treated as an asset which is used for personal, living, and family purposes (and not as an asset used in a trade or business). Thus, the basis of such a facility will be adjusted for purposes of computing depreciation deductions and determining gain or loss on the sale of such facility in the same manner as other property (for example, a residence) which is regarded as used partly for business and partly for personal purposes.

[T.D. 6659, 28 FR 6507, June 25, 1963]

§ 1.274–8 Effective/applicability date.

Except as provided in §§ 1.274–2(a), 1.274–2(e), 1.274–2(f)(2)(iv)(F), and 1.274–5, §§ 1.274–1 through 1.274–7 apply to taxable years ending after December 31, 1962.

[T.D. 9625, 78 FR 46504, Aug. 1, 2013]

§ 1.274–9 Entertainment provided to specified individuals.

(a) *In general*. Paragraphs (e)(2) and (e)(9) of section 274 provide exceptions to the disallowance of section 274(a) for expenses for entertainment, amusement, or recreation activities, or for an entertainment facility. In the case of a specified individual (as defined in paragraph (b) of this section), the exceptions of paragraphs (e)(2) and (e)(9) of section 274 apply only to the extent that the expenses do not exceed the amount of the expenses treated as compensation (under section 274(e)(2)) or as income (under section 274(e)(9)) to the specified individual. The amount disallowed is reduced by any amount that the specified individual reimburses a taxpayer for the entertainment.

(b) *Specified individual defined*. (1) A specified individual is an individual who is subject to section 16(a) of the Securities Act of 1934 in relation to the taxpayer, or an individual who would be subject to section 16(a) if the taxpayer were an issuer of equity securities referred to in that section. Thus, for example, a specified individual is an officer, director, or more than 10 percent owner of a corporation taxed under subchapter C or subchapter S or a personal service corporation. A specified individual includes every individual who—

(i) Is the direct or indirect beneficial owner of more than 10 percent of any class of any registered equity (other than an exempted security);

(ii) Is a director or officer of the issuer of the security;

(iii) Would be the direct or indirect beneficial owner of more than 10 percent of any class of a registered security if the taxpayer were an issuer of equity securities; or

(iv) Is comparable to an officer or director of an issuer of equity securities.

(2) For partnership purposes, a specified individual includes any partner that holds more than a 10 percent equity interest in the partnership, or any general partner, officer, or managing partner of a partnership.

(3) For purposes of this section, *officer* has the same meaning as in 17 CFR § 240.16a–1(f).

(4) A specified individual includes a director or officer of a tax-exempt entity.

(5) A specified individual of a taxpayer includes a specified individual of a party related to the taxpayer within the meaning of section 267(b) or section 707(b).

(c) *Specified individual treated as recipient of entertainment provided to others*. For purposes of section 274(a), a specified individual is treated as the recipient of entertainment provided to another individual because of the relationship of the other individual to the specified individual if the entertainment is a fringe benefit to the specified individual under section 61(a)(1) (without regard to any exclusions from gross income). Thus, expenses allocable to entertainment provided to the other individual are attributed to the specified individual for purposes of determining the amount of disallowed expenses.

(d) *Entertainment use of aircraft by specified individuals*. For rules relating to entertainment use of aircraft by specified individuals, see § 1.274–10.

(e) *Effective/applicability date*. This section applies to taxable years beginning after August 1, 2012.

[T.D. 9597, 77 FR 45483, Aug. 1, 2012]

§ 1.274–10 Special rules for aircraft used for entertainment.

(a) *Use of an aircraft for entertainment*—(1) *In general*. Section 274(a) disallows a deduction for certain expenses for entertainment, amusement, or recreation activities, or for an entertainment facility. Under section 274(a) and this section, no deduction otherwise allowable under chapter 1 is allowed for expenses for the use of a taxpayer-provided aircraft for entertainment, except as provided in paragraph (a)(2) of this section.

(2) *Exceptions*—(i) *In general.* Paragraph (a)(1) of this section does not apply to deductions for expenses for business entertainment air travel or to deductions for expenses that meet the exceptions of section 274(e), §1.274–2(f), and this section. Section 274(e)(2) and (e)(9) provides certain exceptions to the disallowance of section 274(a) for expenses for goods, services, and facilities for entertainment, recreation, or amusement.

(ii) *Expenses treated as compensation*—(A) *Employees who are not specified individuals.* Section 274(a), §1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(2)(A), do not apply to expenses for entertainment air travel provided to an employee who is not a specified individual to the extent that a taxpayer—

(*1*) Properly treats the expenses relating to the recipient of entertainment as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24; and

(*2*) Treats the proper amount as compensation to the employee under §1.61–21.

(B) *Persons who are not employees and are not specified individuals.* Section 274(a), §1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(9), do not apply to expenses for entertainment air travel provided to a person who is not an employee and is not a specified individual to the extent that the expenses are includible in the income of that person. This exception does not apply to any amount paid or incurred by the taxpayer that is required to be included in any information return filed by the taxpayer under part III of subchapter A of chapter 61 and is not so included.

(C) *Specified individuals.* Section 274(a), §1.274–2(a) through (d), and paragraph (a)(1) of this section, in accordance with section 274(e)(2)(B), do not apply to expenses for entertainment air travel of a specified individual to the extent that the amount of the expenses do not exceed the sum of—

(*1*) The amount treated as compensation to or included in the income of the specified individual in the manner specified under paragraph (a)(2)(ii)(A)(1) of this section (if the specified individual is an employee) or under paragraph (a)(2)(ii)(B) of this section (if the specified individual is not an employee); and

(*2*) Any amount the specified individual reimburses the taxpayer.

(iii) *Travel on regularly scheduled commercial airlines.* Section 274(a), §1.274–2(a) through (d), and paragraph (a)(1) of this section do not apply to expenses for entertainment air travel that a taxpayer that is a commercial passenger airline provides to specified individuals of the taxpayer on the taxpayer's regularly scheduled flights on which at least 90 percent of the seats are available for sale to the public to the extent the expenses are includible in the income of the recipient of the entertainment in the manner specified under paragraph (a)(2)(ii)(A)(1) of this section (if the specified individual is an employee) or under paragraph (a)(2)(ii)(B) of this section (if the specified individual is not an employee).

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of this section.

(1) *Entertainment.* For the definition of *entertainment* for purposes of this section, see §1.274–2(b)(1). Entertainment does not include personal travel that is not for entertainment purposes. For example, travel to attend a family member's funeral is not entertainment.

(2) *Entertainment air travel. Entertainment air travel* is any travel aboard a taxpayer-provided aircraft for entertainment purposes.

(3) *Business entertainment air travel. Business entertainment air travel* is any entertainment air travel aboard a taxpayer-provided aircraft that is directly related to the active conduct of the taxpayer's trade or business or related to an expenditure directly preceding or following a substantial and bona fide business discussion and associated with

the active conduct of the taxpayer's trade or business. See §1.274–2(a)(1)(i) and (ii). Air travel is not business entertainment air travel merely because a taxpayer-provided aircraft is used for the travel as a result of a bona fide security concern under §1.132–5(m).

(4) *Taxpayer-provided aircraft.* A *taxpayer-provided aircraft* is any aircraft owned by, leased to, or chartered to, a taxpayer or any party related to the taxpayer (within the meaning of section 267(b) or section 707(b)).

(5) *Specified individual.* For rules relating to the definition of a specified individual, see §1.274–9.

(c) *Amount disallowed.* Except as otherwise provided, the amount disallowed under this section for an entertainment flight by a specified individual is the amount of expenses allocable to the entertainment flight of the specified individual under paragraph (e)(2), (e)(3), or (f)(3) of this section, reduced (but not below zero) by the amount the taxpayer treats as compensation or reports as income under paragraph (a)(2)(ii)(C)(1) of this section to the specified individual, plus any amount the specified individual reimburses the taxpayer.

(d) *Expenses subject to disallowance under this section*—(1) *Definition of expenses.* In determining the amount of expenses subject to disallowance under this section, a taxpayer must include all of the expenses of operating the aircraft, including all fixed and variable expenses the taxpayer deducts in the taxable year. These expenses include, but are not limited to, salaries for pilots, maintenance personnel, and other personnel assigned to the aircraft; meal and lodging expenses of flight personnel; take-off and landing fees; costs for maintenance flights; costs of on-board refreshments, amenities and gifts; hangar fees (at home or away); management fees; costs of fuel, tires, maintenance, insurance, registration, certificate of title, inspection, and depreciation; interest on debt secured by or properly allocated (within the meaning of §1.163–8T) to an aircraft; and all costs paid or incurred for aircraft leased or chartered to the taxpayer.

(2) *Leases or charters to third parties.* Expenses allocable to a lease or charter of a taxpayer's aircraft to an unrelated (as determined under section 267(b) or 707(b)) third-party in a bona-fide business transaction for adequate and full consideration are excluded from the definition of expenses in paragraph (d)(1) of this section. Only expenses allocable to the lease or charter period are excluded under this paragraph (d)(2).

(3) *Straight-line method permitted for determining depreciation disallowance under this section*—(i) *In general.* In lieu of the amount of depreciation deducted in the taxable year, solely for purposes of paragraph (d)(1) of this section, a taxpayer may elect to treat as its depreciation deduction the amount that would result from using the straight-line method of depreciation over the class life (as defined by section 168(i)(1) and using the applicable convention under section 168(d)) of an aircraft, even if the taxpayer uses a different methodology to calculate depreciation for the aircraft under other sections of the Internal Revenue Code (for example, section 168). If the property qualifies for the additional first-year depreciation deduction provided by, for example, section 168(k), 168(n), 1400L(b), or 1400N(d), depreciation for purposes of this straight-line election is determined on the unadjusted depreciable basis (as defined in §1.168(b)–1(a)(3)) of the property. However, the amount of depreciation disallowed as a result of this paragraph (d)(3) for any taxable year cannot exceed a taxpayer's allowable depreciation for that taxable year. For purposes of this section, a taxpayer that elects to use the straight-line method and class life under this paragraph (d)(3) for any aircraft it operates must use that methodology for all depreciable aircraft it operates and must continue to use the methodology for the entire period the taxpayer uses any depreciable aircraft.

(ii) *Aircraft placed in service in earlier taxable years.* The amount of depreciation for purposes of this paragraph (d)(3) for aircraft placed in service in taxable years before the taxable year of the election is determined by applying the straight-line method of depreciation to the unadjusted depreciable basis (or, for property acquired in an exchange to which section 1031 applies, the basis of the aircraft as determined under section 1031(d)) and over the class life (using the applicable convention under section 168(d)) of the aircraft as though the taxpayer used that methodology from the year the aircraft was placed in service.

(iii) *Manner of making and revoking election.* A taxpayer makes the election under this paragraph (d)(3) by filing an income tax return for the taxable year that determines the taxpayer's expenses for purposes of paragraph (d)(1) of this section by computing depreciation under this paragraph (d)(3). A taxpayer may revoke an election only for compelling circumstances upon consent of the Commissioner by private letter ruling.

(4) *Aggregation of aircraft*—(i) *In general.* A taxpayer may aggregate the expenses of aircraft of similar cost profiles for purposes of calculating disallowed expenses under paragraph (c) of this section.

(ii) *Similar cost profiles.* Aircraft are of similar cost profiles if their operating costs per mile or per hour of flight are comparable. Aircraft must have the same engine type (jet or propeller) and the same number of engines to have similar cost profiles. Other factors to be considered in determining whether aircraft have similar cost profiles include, but are not limited to, maximum take-off weight, payload, passenger capacity, fuel consumption rate, age, maintenance costs, and depreciable basis.

(5) *Authority for establishing safe harbors for determining expenses.* The Commissioner may establish in published guidance, see §601.601(d)(2) of this chapter, one or more safe harbor methods under which a taxpayer may determine the amount of expenses paid or incurred for entertainment flights.

(e) *Allocation of expenses*—(1) *General rule.* For purposes of determining the expenses allocated to entertainment air travel of a specified individual under paragraph (a)(2)(ii)(C) of this section, a taxpayer must use either the occupied seat hours or miles method of paragraph (e)(2) of this section or the flight-by-flight method of paragraph (e)(3) of this section. A taxpayer must use the chosen method for all flights of all aircraft for the taxable year.

(2) *Occupied seat hours or miles method*—(i) *In general.* The occupied seat hours or miles method determines the amount of expenses allocated to a particular entertainment flight of a specified individual based on the occupied seat hours or miles for an aircraft for the taxable year. Under this method, a taxpayer may choose to use either occupied seat hours or miles for the taxable year to determine the amount of expenses allocated to entertainment flights of specified individuals, but must use occupied seat hours or miles consistently for all flights of all aircraft for the taxable year.

(ii) *Computation under the occupied seat hours or miles method.* The amount of expenses allocated to an entertainment flight taken by a specified individual is computed under the occupied seat hours or miles method by determining—

(A) The total expenses for the year under paragraph (d) of this section for the aircraft or group of aircraft (if aggregated under paragraph (d)(4) of this section), as applicable;

(B) The number of occupied seat hours or miles for the taxable year for the aircraft or group of aircraft by totaling the occupied seat hours or miles of all flights in the taxable year flown by the aircraft or group of aircraft, as applicable. The occupied seat hours or miles for a flight is the number of hours or miles flown for the flight multiplied by the number of seats occupied on that flight. For example, a flight of 6 hours with three passengers results in 18 occupied seat hours;

(C) The cost per occupied seat hour or mile for the aircraft or group of aircraft, as applicable, by dividing the total expenses under paragraph (e)(2)(ii)(A) of this section by the total number of occupied seat hours or miles under paragraph (e)(2)(ii)(B) of this section; and

(D) The amount of expenses allocated to an entertainment flight taken by a specified individual by multiplying the number of hours or miles of the flight by the cost per occupied hour or mile for that aircraft or group of aircraft, as applicable, as determined under paragraph (e)(2)(ii)(C) of this section.

(iii) *Allocation of expenses of multi-leg trips involving both business and entertainment legs.* A taxpayer that uses the occupied seat hours or miles allocation method must allocate the expenses of a trip by a specified individual that involves at least one segment for business and one segment for entertainment between the business travel and the entertainment travel unless none of the expenses for the entertainment segment are disallowed. The entertainment cost of a multi-leg trip is the total cost of the flights (by occupied seat hours or miles) minus the cost of the flights that would have been taken without the entertainment segment or segments.

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (e)(2):

Example 1. (i) A taxpayer-provided aircraft is used for Flights 1, 2, and 3, of 5 hours, 5 hours, and 4 hours, respectively, during the Taxpayer's taxable year. Each flight carries four passengers. On Flight 1, none of the passengers is a specified individual. On Flight 2, passengers A and B are specified individuals traveling for entertainment purposes and passengers C and D are not specified individuals. For Flight 2, Taxpayer treats $1,200 as compensation to A, and B reimburses Taxpayer $500. On Flight 3, all four passengers (A, B, E, and F) are specified individuals traveling for entertainment purposes. For Flight 3, Taxpayer treats $1,300 each as compensation to A, B, E, and F. Taxpayer incurs $56,000 in expenses for the operation of the aircraft for the taxable year. The aircraft is operated for 56 occupied seat hours for the period (four passengers times 5 hours (20 occupied seat hours) for Flight 1, plus four passengers times 5 hours (20 occupied seat hours) for Flight 2, plus four passengers times 4 hours (16 occupied seat hours) for Flight 3. The cost per occupied seat hour is $1,000 ($56,000/56 hours).

(ii) For purposes of determining the amount disallowed (to the extent not treated as compensation or reimbursed) for entertainment provided to specified individuals, $5,000 ($1,000 × 5 hours) each is allocable to A and B for Flight 2, and $4,000 ($1,000 × 4 hours) each is allocable to A, B, E, and F for Flight 3.

(iii) For Flight 2, because Taxpayer treats $1,200 as compensation to A, and B reimburses Taxpayer $500, Taxpayer may deduct $1,700 of the cost of Flight 2 allocable to A and B. The deduction for the remaining $8,300 cost allocable to entertainment provided to A and B on Flight 2 is disallowed (for A, $5,000 less the $1,200 treated as compensation, and for B, $5,000 less the $500 reimbursed).

(iv) For Flight 3, because Taxpayer treats $1,300 each as compensation to A, B, E, and F, Taxpayer may deduct $5,200 of the cost of Flight 3. The deduction for the remaining $10,800 cost allocable to entertainment provided to A, B, E, and F on Flight 3 is disallowed ($4,000 less the $1,300 treated as compensation to each specified individual).

Example 2. (i) G, a specified individual, is the sole passenger on an aircraft that makes three flights. First, G travels on a two-hour flight from City A to City B for business purposes. G then travels on a three-hour flight from City B to City C for entertainment purposes, and returns from City C to City A on a four-hour flight. G's flights have resulted in nine occupied seat hours (two for the first segment, plus three for the second segment, plus four for the third segment). If G had returned directly to City A from City B, the flights would have resulted in four occupied seat hours.

(ii) Under paragraph (e)(2)(iii) of this section, five occupied seat hours are allocable to G's entertainment (nine total occupied seat hours minus the four occupied seat hours that would have resulted if the travel had been a roundtrip business trip without the entertainment segment). If Taxpayer's cost per occupied seat hour for the year is $1,000, $5,000 is allocated to G's entertainment use of the aircraft ($1,000 × five occupied seat hours). The amount disallowed is $5,000 minus the total of any amount the Taxpayer treats as compensation to G plus any amount that G reimburses Taxpayer.

(3) *Flight-by-flight method*—(i) *In general.* The flight-by-flight method determines the amount of expenses allocated to a particular entertainment flight of a specified individual on a flight-by-flight basis by allocating expenses to individual flights and then to a specified individual traveling for entertainment purposes on that flight.

(ii) *Allocation of expenses.* A taxpayer using the flight-by-flight method must combine all expenses (as defined in paragraph (d)(1) of this section) for the taxable year for the aircraft or group of aircraft (if aggregated under paragraph (d)(4) of this section), as applicable, and divide the total amount of expenses by the number of flight hours or miles for the taxable year for that aircraft or group of aircraft, as applicable, to determine the cost per hour or mile. Expenses are allocated to each flight by multiplying the number of miles for the flight by the cost per mile or the number of hours for the flight by the cost per hour. The expenses for the flight then are allocated to the passengers on the flight per capita. Thus, if five passengers are traveling on a flight, and the total expense allocated to the flight is $10,000, the expense allocable to each passenger is $2,000.

(f) *Special rules*—(1) *Determination of basis*. (i) If any deduction for depreciation is disallowed under this section, the rules of § 1.274–7 apply. In that case, the basis of an aircraft is not reduced for the amount of depreciation disallowed under this section.

(ii) The provisions of this paragraph (f)(1) are illustrated by the following examples:

Example 1. (i) B Co. is a calendar-year taxpayer that owns an aircraft not used in commercial or contract carrying of passengers or freight. The aircraft is placed in service on July 1 of Year 1 and has an unadjusted depreciable basis of $1,000,000. The class life of the aircraft for depreciation purposes is 6 years. For determining depreciation under section 168, B Co. uses the optional depreciation table that corresponds with the general depreciation system, the 200 percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. For determining the depreciation disallowance for each year under paragraph (d)(3) of this section, B Co. elects to use the straight-line method of depreciation and the class life of 6 years and, therefore, uses the optional depreciation table for purposes of section 168 that corresponds with the straight-line method of depreciation, a recovery period of 6 years, and the half-year convention. In each year, the aircraft entertainment use subject to disallowance under this section is 10 percent of the total use.

(ii) B Co. calculates the depreciation and basis of the aircraft as follows:

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274–7 Basis of aircraft	Suspended basis.
Year 1	200,000	83,300	8,330. (.10 × 83,300).	191,670 (200,000 minus 8,330).	808,330 (1,000,000 minus 191,670).	8,330.
Year 2	320,000	166,700	16,670 (.10 × 166,700).	303,330 (320,000 minus 16,670).	505,000 (808,330 minus 303,330).	25,000 (8,300 plus 16,670).
Year 3	192,000	166,700	16,670 (.10 × 166,700).	175,330 (192,000 minus 16,670).	329,670 (505,000 minus 175,330).	41,670 (25,000 plus 16,670).
Year 4	115,200	166,700	16,670 (.10 × 166,700).	98,530 (115,200 minus 16,670).	231,140 (329,670 minus 98,530).	58,340 (41,670 plus 16,670).
Year 5	115,200	166,600	16,660 (.10 × 166,600).	98,540 (115,200 minus 16,660).	132,600 (231,140 minus 98,540).	75,000 (58,340 plus 16,660).
Year 6	57,600	166,700	16,670 (.10 × 166,700).	40,930 (57,600 minus 16,670).	91,670 (132,600 minus 40,930).	91,670 (75,000 plus 16,670).
Year 7		83,300	8,330 (.10 × 83,300).		91,670	91,670.

(iii) In Year 7, there is no further deduction for depreciation of the aircraft, therefore, under paragraph (d)(3) of this section, no depreciation expense is disallowed. Under § 1.274–7 and this paragraph (f)(1), basis is not reduced for disallowed depreciation. Therefore, at the end of Year 7, the basis of the aircraft for purposes of § 1.274–7 is $91,670, which is the total amount of disallowed depreciation in Years 1 through 6. B Co.'s deductions for depreciation total $908,330, which added to $91,670 equals $1,000,000.

Example 2. (i) The facts are the same as in *Example 1*, except that B Co. does not elect to use the straight-line method of depreciation under paragraph (d)(3) of this section until Year 3.

(ii) B Co. calculates the depreciation and basis of the aircraft as follows:

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274 Basis of aircraft	Suspended basis.
Year 1	200,000		20,000 (.10 × 200,000).	180,000	820,000 (1,000,000 minus 180,000).	20,000.
Year 2	320,000		32,000 (.10 × 320,000).	288,000 (320,000 minus 32,000).	532,000 (820,000 minus 288,000).	52,000 (20,000 plus 32,000).

	200 Percent declining balance depreciation amount	Straight line depreciation amount	Depreciation disallowance under section 274	Depreciation deduction	§ 1.274 Basis of aircraft	Suspended basis.
Year 3	192,000	166,700	16,670 (.10 × 166,700).	175,330 (192,000 minus 16,670).	356,670 (532,000 minus 175,330).	68,670 (52,000 plus 16,670).
Year 4	115,200	166,700	16,670 (.10 × 166,700).	98,530 (115,200 minus 16,670).	258,140 (356,670 minus 98,530).	85,340 (68,670 plus 16,670).
Year 5	115,200	166,600	16,660 (.10 × 166,600).	98,540 (115,200 minus 16,660).	159,600 (258,140 minus 98,540).	102,000 (85,340 plus 16,660).
Year 6	57,600	166,700	16,670 (.10 × 166,700).	40,930 (57,600 minus 16,670).	118,670 (159,600 minus 40,930).	118,670 (102,000 plus 16,670).
Year 7	....	83,300	8,330 (.10 × 83,300).	0	118,670	118,670.

(iii) In Year 7, there is no further deduction for depreciation of the aircraft, therefore, under paragraph (d)(3) of this section, no depreciation expense is disallowed. Under §1.274–7 and this paragraph (f)(1), basis is not reduced for disallowed depreciation. Therefore, at the end of Year 7, the basis of the aircraft for purposes of §1.274–7 is $118,670, which is the total amount of disallowed depreciation in Years 1 through 6. B Co.'s deductions for depreciation total $881,330, which added to $118,670 equals $1,000,000.

(2) *Pro rata disallowance.* (i) The amount of disallowed expenses, and any amounts reimbursed or treated as compensation, under this section are applied on a pro rata basis to all of the categories of expenses subject to disallowance under this section.

(ii) The provisions of this paragraph (f)(2) are illustrated by the following example:

Example. (i) C Co. owns an aircraft that it uses for business and other purposes. The expenses of operating the aircraft in the current year total $1,000,000. This amount includes $250,000 for depreciation (25 percent of total expenses).

(ii) In the same year, the aircraft entertainment use subject to disallowance under this section is 20 percent of the total use and C Co. treats $80,000 as compensation to specified individuals. Thus, the amount of the disallowance under this section is $120,000 ($1,000,000 × 20 percent ($200,000) less $80,000).

(iii) Under paragraph (f)(2) of this section, C Co. may calculate the amount by which a category of expense, such as depreciation, is disallowed by multiplying the total disallowance of $120,000 by the ratio of the amount of the expense to total expenses. Thus, $30,000 of the $120,000 total disallowed expenses is depreciation ($250,000/$1,000,000 (25 percent) × $120,000).

(iv) The result is the same if C Co. separately calculates the amount of depreciation in total disallowed expenses and in the amount treated as compensation and nets the result. Depreciation is 25 percent of total expenses, thus, the amount of depreciation in disallowed expenses is $50,000 (25 percent × $200,000 total disallowed expenses) and the amount of depreciation treated as compensation is $20,000 (25 percent × $80,000). Disallowed depreciation is $50,000 less $20,000, or $30,000.

(3) *Deadhead flights.* (i) For purposes of this section, an aircraft returning without passengers after discharging passengers or flying without passengers to pick up passengers (deadheading) is treated as having the same number and character of passengers as the leg of the trip on which passengers are aboard for purposes of allocating expenses under paragraphs (e)(2) or (e)(3) of this section. For example, when an aircraft travels from point A to point B and then back to point A, and one of the legs is a deadhead flight, for determination of disallowed expenses, the aircraft is treated as having made both legs of the trip with the same passengers aboard for the same purposes.

(ii) When a deadhead flight does not occur within a roundtrip flight, but occurs between two unrelated flights involving more than two destinations (such as an occupied flight from point A to point B, followed by a deadhead flight from point B to point C, and then an occupied flight from point C to point A), the allocation of passengers and expenses to the deadhead flight occurring between the two occupied trips must be based solely on the number of passengers on board for the two occupied legs of the flight, the character of the travel of the passengers on board (entertainment or nonentertainment) and the length in hours or miles of the two occupied legs of the flight.

(iii) The provisions of this paragraph (f)(3) are illustrated by the following examples:

Example 1. (i) Aircraft flies from City A to City B, a 6-hour trip, with 12 passengers aboard. Eight of the passengers are traveling for business and four of the passengers are specified individuals traveling for entertainment purposes. The aircraft flies empty (deadheads) from City B to City C, a 4-hour trip. At City C it picks up 12 passengers, six of whom are traveling for business and six of whom are specified individuals traveling for entertainment purposes, for a 2-hour trip to City A. The taxpayer uses the occupied seat hour method of allocating expenses.

(ii) The two legs of the trip on which the aircraft is occupied comprise 96 occupied seat hours (12 passengers × 6 hours (72) for the first leg plus 12 passengers × 2 hours (24) for the third leg). Sixty occupied seat hours are for business (8 passengers × 6 hours (48) for the first leg plus 6 passengers × 2 (12) hours for the third leg) and 36 occupied seat hours are for entertainment purposes (4 passengers × 6 hours (24) for the first leg plus 6 passengers × 2 (12) hours for the third leg). Dividing the 36 occupied seat entertainment hours by 96 total occupied seat hours, 37.5 percent of the total occupied seat hours of the two occupied flights are for entertainment.

(iii) The 4-hour deadhead leg comprises one-third of the total flight time of 12 hours. Therefore, the deadhead flight is deemed to have provided one-third of the total 96 occupied seat hours, or 32 occupied seat hours ($96 \times 1/3 = 32$). Of the 32 deemed occupied seat hours, 37.5 percent, or 12 deemed occupied seat hours, are treated as entertainment under paragraph (f)(3)(ii) of this section. The 32 deemed occupied seat hours for the deadhead flight are included in the calculation under paragraph (e)(2)(ii)(B) of this section and expenses are allocated under paragraph (e)(2)(ii)(D) of this section to the 12 deemed occupied seat hours treated as entertainment.

Example 2. (i) The facts are the same as for *Example 1*, but the taxpayer uses the flight-by-flight method of allocation.

(ii) Of the 24 passengers on the occupied flights, 10 passengers, or 41.7 percent, are traveling for entertainment purposes. If the annual cost per flight hour calculated under paragraph (e)(3)(ii) of this section is $1,000, $4,000 is allocated to the 4-hour deadhead leg. Under paragraph (f)(3)(ii) of this section, 41.7 percent of the $4,000, or $1,667, is treated as an expense for entertainment. The calculation of the cost per mile or hour for the year under paragraph (e)(3)(ii) of this section includes the expenses and number of miles or hours flown for the deadhead leg.

(g) *Effective/applicability date.* This section applies to taxable years beginning after August 1, 2012.

[T.D. 9597, 77 FR 45483, Aug. 1, 2012]

§ 1.274–11 Disallowance of deductions for certain entertainment, amusement, or recreation expenditures paid or incurred after December 31, 2017.

(a) *In general.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code (Code) is allowed for any expenditure with respect to an activity that is of a type generally considered to be entertainment, or with respect to a facility used in connection with an entertainment activity. For this purpose, dues or fees to any social, athletic, or sporting club or organization are treated as items with respect to facilities and, thus, are not deductible. In addition, no deduction otherwise allowable under chapter 1 of the Code is allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

(b) *Definitions*—(1) *Entertainment*—(i) *In general.* For section 274 purposes, the term *entertainment* means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. These activities are treated as entertainment under this section, subject to the objective test, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. The term *entertainment* may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living, or family needs of any individual, such as providing a hotel suite or an automobile to a business customer or the customer's family. The term *entertainment* does not include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as the providing of a hotel room maintained by an employer for lodging of employees while in business travel status or an automobile used in the active conduct of a trade or business even though used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee.

(ii) *Food or beverages.* Under this section, the term *entertainment* does not include food or beverages unless the food or beverages are provided at or during an entertainment activity. Food or beverages provided at or during an entertainment activity generally are treated as part of the entertainment activity. However, in the case of food or beverages provided at or during an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment or must approximate the reasonable value of those items. If the food or beverages are not purchased separately from the entertainment, or the cost of the food or beverages is not stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation between entertainment and food or beverage expenses may be made and, except as further provided in this section and section 274(e), the entire amount is a nondeductible entertainment expenditure under this section and section 274(a).

(iii) *Objective test.* An objective test is used to determine whether an activity is of a type generally considered to be entertainment. Thus, if an activity is generally considered to be entertainment, it will be treated as entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments that *entertainment* means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business is considered. Thus, although attending a theatrical performance generally would be considered entertainment, it would not be so considered in the case of a professional theater critic attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment. However, if an appliance distributor conducts a fashion show, the fashion show generally would be considered to be entertainment.

(2) *Expenditure.* The term *expenditure* as used in this section includes amounts paid or incurred for goods, services, facilities, and other items, including items such as losses and depreciation.

(3) *Expenditures for production of income.* For purposes of this section, any reference to *trade or business* includes an activity described in section 212.

(c) *Exceptions.* Paragraph (a) of this section does not apply to any expenditure described in section 274(e)(1), (2), (3), (4), (5), (6), (7), (8), or (9).

(d) *Examples.* The following examples illustrate the application of paragraphs (a) and (b) of this section. In each example, assume that the taxpayer is engaged in a trade or business for purposes of section 162 and that neither the taxpayer nor any business associate is engaged in a trade or business that relates to the entertainment activity. Also assume that none of the exceptions under section 274(e) and paragraph (c) of this section apply.

(1) *Example 1.* Taxpayer A invites, B, a business associate, to a baseball game to discuss a proposed business deal. A purchases tickets for A and B to attend the game. The baseball game is entertainment as defined in §1.274–11(b)(1) and thus, the cost of the game tickets is an entertainment expenditure and is not deductible by A.

(2) *Example 2.* The facts are the same as in paragraph (d)(1) of this section (*Example 1)*, except that A also buys hot dogs and drinks for A and B from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the disallowance under § 1.274–11(a) and section 274(a)(1). Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game if the expenses meet the requirements of section 162 and § 1.274–12.

(3) *Example 3.* Taxpayer C invites D, a business associate, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food or beverages. The basketball game is entertainment as defined in § 1.274–11(b)(1), and, thus, the cost of the game tickets is an entertainment expenditure and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages is an entertainment expenditure that is subject to disallowance under section 274(a)(1) and paragraph (a) of this section, and C may not deduct the cost of the tickets or the food and beverages associated with the basketball game.

(4) *Example 4.* The facts are the same as in paragraph (d)(3) of this section (*Example 3*), except that the invoice for the basketball game tickets separately states the cost of the food and beverages and reflects the venue's usual selling price if purchased separately. As in paragraph (d)(3) of this section (*Example 3*), the basketball game is entertainment as defined in § 1.274–11(b)(1), and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expenditure and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets and reflects the venue's usual selling price of the food and beverages if purchased separately, is not an entertainment expenditure and is not subject to the disallowance under section 274(a)(1) and paragraph (a) of this section. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game if the expenses meet the requirements of section 162 and § 1.274–12.

(e) *Applicability date.* This section applies for taxable years that begin on or after October 9, 2020.

[T.D. 9925, 85 FR 64033, Oct. 9, 2020]

§ 1.274–12 Limitation on deductions for certain food or beverage expenses paid or incurred after December 31, 2017.

(a) *Food or beverage expenses*—(1) *In general.* Except as provided in this section, no deduction is allowed for the expense of any food or beverages provided by the taxpayer (or an employee of the taxpayer) unless—

(i) The expense is not lavish or extravagant under the circumstances;

(ii) The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and

(iii) The food or beverages are provided to the taxpayer or a business associate.

(2) *Only 50 percent of food or beverage expenses allowed as deduction.* Except as provided in this section, the amount allowable as a deduction for any food or beverage expense described in paragraph (a)(1) of this section may not exceed 50 percent of the amount of the expense that otherwise would be allowable.

(3) *Examples.* The following examples illustrate the application of paragraph (a)(1) and (2) of this section. In each example, assume that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business and are not lavish or extravagant under the circumstances. Also assume that none of the exceptions in paragraph (c) of this section apply.

(i) *Example 1.* Taxpayer A takes client B out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, A may deduct 50 percent of the food or beverage expenses.

(ii) *Example 2.* Taxpayer C takes employee D out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, C may deduct 50 percent of the food or beverage expenses.

(iii) *Example 3*. Taxpayer E holds a business meeting at a hotel during which food and beverages are provided to attendees. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses.

(iv) *Example 4*. The facts are the same as in paragraph (a)(3)(iii) of this section (Example 3), except that all the attendees of the meeting are employees of E. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses. The exception in section 274(e)(5) does not apply to food and beverage expenses under section 274(k) and (n).

(4) *Special rules for travel meals*. (i) *In general*. Food or beverage expenses paid or incurred while traveling away from home in pursuit of a trade or business generally are subject to the deduction limitations in section 274(k) and (n) and paragraph (a)(1) and (2) of this section, as well as the substantiation requirements in section 274(d). In addition, travel expenses generally are subject to the limitations in section 274(m)(1), (2), and (3).

(ii) *Substantiation*. Except as provided in this section, no deduction is allowed for the expense of any food or beverages paid or incurred while traveling away from home in pursuit of a trade or business unless the taxpayer meets the substantiation requirements in section 274(d).

(iii) *Travel meal expenses of spouse, dependent or others*. No deduction is allowed under chapter 1 of the Internal Revenue Code (Code), except under section 217 for certain members of the Armed Forces of the United States, for the expense of any food or beverages paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer, or an officer or employee of the taxpayer, on business travel, unless—

(A) The spouse, dependent, or other individual is an employee of the taxpayer;

(B) The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and

(C) The expenses would otherwise be deductible by the spouse, dependent or other individual.

(D) *Example*. The following example illustrates the application of paragraph (a)(4)(iii) of this section:

(*1*) *Example*. Taxpayer F, a sole proprietor, and Taxpayer F's spouse travel from New York to Boston to attend a series of business meetings related to F's trade or business. F's spouse is not an employee of F, does not travel to Boston for a bona fide business purpose of F, and the expenses would not otherwise be deductible. While in Boston, F and F's spouse go out to dinner. Under section 274(m)(3) and paragraph (a)(4)(iii) of this section, the expenses associated with the food and beverages consumed by F's spouse are not deductible. Therefore, the cost of F's spouse's dinner is not deductible. F may deduct 50 percent of the expense associated with the food and beverages F consumed while on business travel if F meets the requirements in sections 162 and 274, including section 274(k) and (d).

(*2*) [Reserved]

(b) *Definitions*. Except as otherwise provided in this section, the following definitions apply for purposes of section 274(k) and (n), §1.274–11(b)(1)(ii) and (d), and this section:

(1) *Food or beverages. Food or beverages* means all food and beverage items, regardless of whether characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as *de minimis* fringes under section 132(e).

(2) *Food or beverage expenses. Food or beverage expenses* mean the full cost of food or beverages, including any delivery fees, tips, and sales tax. In the case of employer-provided meals furnished

at an eating facility on the employer's business premises, *food or beverage expenses* do not include expenses for the operation of the eating facility such as salaries of employees preparing and serving meals and other overhead costs.

(3) *Business associate*. *Business associate* means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.

(4) *Independent contractor*. For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, *independent contractor* means a person who is not an employee of the payor.

(5) *Client or customer*. For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, *client* or *customer* of an independent contractor means a person who receives services from an independent contractor and enters into a reimbursement or other expense allowance arrangement with the independent contractor.

(6) *Payor*. For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, *payor* means a person that enters into a reimbursement or other expense allowance arrangement with an employee and may include an employer, its agent, or a third party.

(7) *Reimbursement or other expense allowance arrangement*. For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, *reimbursement or other expense allowance arrangement* means—

(i) For purposes of paragraph (c)(2)(ii)(B) of this section, an arrangement under which an employee receives an advance, allowance, or reimbursement from a payor for expenses the employee pays or incurs; and

(ii) For purposes of paragraph (c)(2)(ii)(C) of this section, an arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either—

(A) A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions described in paragraph (a) of this section; or

(B) A written agreement between the parties expressly identifies the party subject to the limitations.

(8) *Primarily consumed*. For purposes of paragraph (c)(2)(iv) of this section, *primarily consumed* means greater than 50 percent of actual or reasonably estimated consumption.

(9) *General public*. For purposes of paragraph (c)(2)(iv) of this section, the *general public* includes, but is not limited to, customers, clients, and visitors. The *general public* does not include employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), or independent contractors of the taxpayer. Also, the guests on an exclusive list of guests are not the *general public*.

(c) *Exceptions*—(1) *In general*. The limitations on the deduction of food or beverage expenses in paragraph (a) of this section do not apply to any expense described in paragraph (c)(2) of this section. These expenses are deductible to the extent allowable under chapter 1 of the Code (chapter 1).

(2) *Exceptions*—(i) *Expenses treated as compensation*—(A) *Expenses includible in income of persons who are employees and are not specified individuals*. In accordance with section 274(e)(2)(A), and except as provided in paragraph (c)(2)(i)(D) of this section, an expense paid or incurred by a taxpayer for food or beverages, if an employee who is not a specified individual is the recipient of the food or beverages, is not subject to the deduction limitations in paragraph (a) of this section to the extent that the taxpayer—

(*1*) Properly treats the expense relating to the recipient of food or beverages as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24 of the Code (chapter 24).; and

(*2*) Treats the proper amount as compensation to the employee under § 1.61–21.

(B) *Expenses includible in income of persons who are not employees and are not specified individuals.* In accordance with section 274(e)(9), and except as provided in paragraph (c)(2)(i)(D) of this section, an expense paid or incurred by a taxpayer for food or beverages is not subject to the deduction limitations in paragraph (a) of this section to the extent that the expenses are properly included in income as compensation for services rendered by, or as a prize or award under section 74 to, a recipient of the expense who is not an employee of the taxpayer and is not a specified individual. The preceding sentence does not apply to any amount paid or incurred by the taxpayer if the amount is required to be included, or would be so required except that the amount is less than $600, in any information return filed by such taxpayer under part III of subchapter A of chapter 61 of the Code and is not so included.

(C) *Specified Individuals.* In accordance with section 274(e)(2)(B), in the case of a specified individual (as defined in section 274(e)(2)(B)(ii)), the deduction limitations in paragraph (a) of this section do not apply to an expense for food or beverages of the specified individual to the extent that the amount of the expense does not exceed the sum of—

(*1*) The amount treated as compensation to the specified individual under chapter 1 and as wages to the specified individual for purposes of chapter 24 (if the specified individual is an employee) or as compensation for services rendered by, or as a prize or award under section 74 to, a recipient of the expense (if the specified individual is not an employee); and

(*2*) Any amount the specified individual reimburses the taxpayer.

(D) *Expenses for which an amount is excluded from income or is less than the proper amount.* Notwithstanding paragraphs (c)(2)(i)(A) and (B) of this section, in the case of an expense paid or incurred by a taxpayer for food or beverages for which an amount is wholly or partially excluded from a recipients' income under any section of subtitle A of the Code (other than because the amount is reimbursed by the recipient), or for which an amount included in compensation and wages to an employee (or as income to a nonemployee) is less than the amount required to be included under § 1.61–21, the deduction limitations in paragraph (a) of this section do not apply to the extent that the amount of the expense does not exceed the sum of—

(*1*) The amount treated as compensation to the employee under chapter 1 (or as income to a nonemployee) and as wages to the employee for purposes of chapter 24; and

(*2*) Any amount the recipient reimburses the taxpayer.

(E) *Examples.* The following examples illustrate the application of paragraph (c)(2)(i) of this section. In each example, assume that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business.

(*1*) *Example 1.* Employer G provides food and beverages to its non-specified individual employees without charge at a company cafeteria on its premises. The food and beverages do not meet the definition of a *de minimis* fringe under section 132(e). Thus, G treats the full fair market value of the food and beverage expenses as compensation and wages, and properly determines this amount under § 1.61–21. Under section 274(e)(2) and paragraph (c)(2)(i)(A) of this section, the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitation in paragraph (a) of this section. Thus, G may deduct 100 percent of the food and beverage expenses.

(*2*) *Example 2.* The facts are the same as in paragraph (c)(2)(i)(E)(*1*) of this section (*Example 1*), except that each employee pays $8 per day for the food and beverages. The fair market value of the food and beverages is $10 per day, per employee. G incurs $9 per day, per employee for the food and beverages. G treats the food and beverage expenses as compensation and wages, and properly determines the amount of the inclusion under § 1.61–21 to be $2 per day, per employee ($10 fair market value − $8 reimbursed by the employee = $2).

Therefore, under paragraph (c)(2)(i)(A) of this section, G may deduct 100 percent of the food and beverage expenses, or $9 per day, per employee.

(*3*) *Example 3*. Employer H provides meals to its employees without charge. The meals are properly excluded from the employees' income under section 119 as meals provided for the convenience of the employer. Under § 1.61–21(b)(1), an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount, if any, paid for the benefit by or on behalf of the recipient, and the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code. Because the entire value of the employees' meals is excluded from the employees' income under section 119, the fair market value of the fringe benefit does not exceed the amount excluded from gross income under subtitle A of the Code, so there is nothing to be included in the employees' income under § 1.61–21. Thus, the exception in section 274(e)(2) and paragraph (c)(2)(i) of this section does not apply and, assuming no other exceptions provided under section 274(n)(2) and paragraph (c)(2) of this section apply, H may deduct only 50 percent of the expenses for the food and beverages provided to employees. In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply because none of the exceptions in section 274(k)(2) and paragraph (c)(2) of this section apply.

(ii) *Reimbursed food or beverage expenses*—(A) *In general*. In accordance with section 274(e)(3), in the case of expenses for food or beverages paid or incurred by one person in connection with the performance of services for another person, whether or not the other person is an employer, under a reimbursement or other expense allowance arrangement, the deduction limitations in paragraph (a) of this section apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. If an expense of a type described in paragraph (c)(2)(ii) of this section properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, a personal expense, or other nondeductible expense, nothing in this exception prevents disallowance of the deduction to the taxpayer under other provisions of the Code.

(B) *Reimbursement arrangements involving employees*. In the case of expenses paid or incurred by an employee for food or beverages in performing services as an employee under a reimbursement or other expense allowance arrangement with a payor, the limitations on deductions in paragraph (a) of this section apply—

(*1*) To the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and as wages to the employee for purposes of withholding under chapter 24 relating to collection of income tax at source on wages; or

(*2*) To the payor to the extent the reimbursement or other payment of the expense is not treated as compensation and wages paid to the employee in the manner provided in paragraph (c)(2)(ii)(B)(*1*) of this section. However, see paragraph (c)(2)(ii)(C) of this section if the payor receives a payment from a third party that may be treated as a reimbursement arrangement under that paragraph.

(C) *Reimbursement arrangements involving persons that are not employees*. In the case of expenses for food or beverages paid or incurred by an independent contractor in connection with the performance of services for a client or customer under a reimbursement or other expense allowance arrangement with the independent contractor, the limitations on deductions in paragraph (a) of this section apply to the party expressly identified in an agreement between the parties as subject to the limitations. If an agreement between the parties does not expressly identify the party subject to the limitations, then the deduction limitations in paragraph (a) of this section apply—

(*1*) To the independent contractor (which may be a payor) to the extent the independent contractor does not account to the client or customer within the meaning of section 274(d); or

(*2*) To the client or customer if the independent contractor accounts to the client or customer within the meaning of section 274(d).

(D) *Section 274(d) substantiation.* If the reimbursement or other expense allowance arrangement involves persons who are not employees and the agreement between the parties does not expressly identify the party subject to the limitations on deductions in paragraph (a) of this section, the limitations on deductions in paragraph (a) of this section apply to the independent contractor unless the independent contractor accounts to the client or customer with substantiation that satisfies the requirements of section 274(d).

(E) *Examples.* The following examples illustrate the application of paragraph (c)(2)(ii) of this section.

(*1*) *Example 1.* (*i*) Employee I performs services under an arrangement in which J, an employee leasing company, pays I a per diem allowance of $10x for each day that I performs services for J's client, K, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that I pays in performing services as an employee. J enters into a written agreement with K under which K agrees to reimburse J for any substantiated reimbursements for travel expenses, including meal expenses, that J pays to I. The agreement does not expressly identify the party that is subject to the limitations on deductions in paragraph (a) of this section. I performs services for K while traveling away from home for 10 days and provides J with substantiation that satisfies the requirements of section 274(d) of $100x of meal expenses incurred by I while traveling away from home. J pays I $100x to reimburse those expenses pursuant to their arrangement. J delivers a copy of I's substantiation to K. K pays J $300x, which includes $200x compensation for services and $100x as reimbursement of J's payment of I's travel expenses for meals. Neither J nor K treats the $100x paid to I as compensation or wages.

(*ii*) Under paragraph (b)(7)(i) of this section, I and J have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(B)(*1*) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Instead, under paragraph (c)(2)(ii)(B)(*2*) of this section, J, the payor, is subject to limitations on deductions in paragraph (a) of this section unless J can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section.

(*iii*) Because the agreement between J and K expressly states that K will reimburse J for substantiated reimbursements for travel expenses that J pays to I, under paragraph (b)(7)(ii)(A) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. J accounts to K for K's reimbursement in the manner required by section 274(d) by delivering to K a copy of the substantiation J received from I. Therefore, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C)(*2*) of this section, K and not J is subject to the deduction limitations in paragraph (a) of this section.

(*2*) *Example 2.* (*i*) The facts are the same as in paragraph (c)(2)(ii)(E)(*1*) of this section (*Example 1)* except that, under the arrangements between I and J and between J and K, I provides the substantiation of the expenses directly to K, and K pays the per diem directly to I.

(*ii*) Under paragraph (b)(7)(i) of this section, I and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because I substantiates directly to K and the reimbursement payment was not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(C)(*1*) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Under paragraph (c)(2)(ii)(C)(*2*) of this section, K, the payor, is subject to the limitations on deductions in paragraph (a) of this section.

(*3*) *Example 3.* (*i*) The facts are the same as in paragraph (c)(2)(ii)(E)(*1*) of this section (*Example 1)*, except that the written agreement between J and K expressly provides that the limitations of this section will apply to K.

(*ii*) Under paragraph (b)(7)(ii)(B) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to K, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section, K and not J is subject to the limitations on deductions in paragraph (a) of this section.

(*4*) *Example 4*. (*i*) The facts are the same as in (c)(2)(ii)(E)(*1*) of this section (*Example 1)*, except that the agreement between J and K does not provide that K will reimburse J for travel expenses.

(*ii*) The arrangement between J and K is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (b)(7)(ii) of this section. Therefore, even though J accounts to K for the expenses, J is subject to the limitations on deductions in paragraph (a) of this section.

(iii) *Recreational expenses for employees*—(A) *In general*. In accordance with section 274(e)(4), any food or beverage expense paid or incurred by a taxpayer for a recreational, social, or similar activity, primarily for the benefit of a taxpayer's employees (other than employees who are highly compensated employees (within the meaning of section 414(q))) is not subject to the deduction limitations in paragraph (a) of this section. For purposes of this paragraph (c)(2)(iii), an employee owning less than a 10-percent interest in the taxpayer's trade or business is not considered a shareholder or other owner, and for such purposes an employee is treated as owning any interest owned by a member of the employee's family (within the meaning of section 267(c)(4)). Any expense for food or beverages that is made under circumstances which discriminate in favor of highly compensated employees is not considered to be made primarily for the benefit of employees generally. An expense for food or beverages is not to be considered outside of the exception of this paragraph (c)(2)(iii) merely because, due to the large number of employees involved, the provision of food or beverages is intended to benefit only a limited number of employees at one time, provided the provision of food or beverages does not discriminate in favor of highly compensated employees. This exception applies to expenses paid or incurred for events such as holiday parties, annual picnics, or summer outings. This exception does not apply to expenses for meals the value of which is excluded from employees' income under section 119 because the meals are provided for the convenience of the employer and are therefore not primarily for the benefit of the taxpayer's employees.

(B) *Examples*. The following examples illustrate the application of this paragraph (c)(2)(iii). In each example, assume that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business.

(*1*) *Example 1*. Employer L invites all employees to a holiday party in a hotel ballroom that includes a buffet dinner and an open bar. Under section 274(e)(4), this paragraph (c)(2)(iii), and §1.274–11(c), the cost of the party, including food and beverage expenses, is not subject to the deduction limitations in paragraph (a) of this section because the holiday party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees. Thus, L may deduct 100 percent of the cost of the party.

(*2*) *Example 2*. The facts are the same as in paragraph (c)(2)(iii)(B)(*1*) of this section (*Example 1)*, except that Employer L invites only highly-compensated employees to the holiday party, and the invoice provided by the hotel lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue's usual selling price for food or beverages. The exception in this paragraph (c)(2)(iii) does not apply to the rental of the ballroom or the food and beverage expenses because L invited only highly-compensated employees to the holiday party. However, under §1.274–11(b)(1)(ii), the food and beverage expenses are not treated as entertainment. Therefore, L is not subject to the full disallowance for its separately stated food and beverage expense under section 274(a)(1) and §1.274–

11(a). Unless another exception in section 274(n)(2) and paragraph (c)(2) of this section applies, L may deduct only 50 percent of the food and beverage costs under paragraph (a)(2) of this section. In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply because none of the exceptions in section 274(k)(2) and paragraph (c)(2) of this section apply.

(*3*) *Example 3.* Employer M provides free coffee, soda, bottled water, chips, donuts, and other snacks in a break room available to all employees. A break room is not a recreational, social, or similar activity primarily for the benefit of the employees, even if some socializing related to the food and beverages provided occurs. Thus, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply and unless another exception in section 274(n)(2) and paragraph (c)(2) of this section applies, M may deduct only 50 percent of the expenses for food and beverages provided in the break room under paragraph (a)(2) of this section. In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply because none of the exceptions in section 274(k)(2) and paragraph (c)(2) of this section apply.

(*4*) *Example 4.* Employer N has a written policy that employees in a certain medical services-related position must be available for emergency calls due to the nature of the position that requires frequent emergency responses. Because these emergencies can and do occur during meal periods, N furnishes food and beverages to employees in this position without charge in a cafeteria on N's premises. N excludes food and beverage expenses from the employees' income as meals provided for the convenience of the employer excludable under section 119. Because these food and beverages are furnished for the employer's convenience, and therefore are not primarily for the benefit of the employees, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even if some socializing related to the food and beverages provided occurs. Further, the exception in section 274(e)(2) and paragraph (c)(2)(i) of this section does not apply. Thus, unless another exception in section 274(n)(2) and paragraph (c)(2) of this section applies, N may deduct only 50 percent of the expenses for food and beverages provided to employees in the cafeteria under paragraph (a)(2) of this section. In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply because none of the exceptions in section 274(k)(2) and paragraph (c)(2) of this section apply.

(*5*) *Example 5.* Employer O invites an employee and a client to dinner at a restaurant. Because it is the birthday of the employee, O orders a special dessert in celebration. Because the meal is a business meal, and therefore not primarily for the benefit of the employee, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even though an employee social activity in the form of a birthday celebration occurred during the meal. Thus, unless another exception in section 274(n)(2) and paragraph (c)(2) of this section applies, O may deduct only 50 percent of the meal expense. In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply because none of the exceptions in section 274(k)(2) and paragraph (c)(2) of this section apply.

(iv) *Items available to the public*—(A) *In general.* In accordance with section 274(e)(7), any expense paid or incurred by a taxpayer for food or beverages to the extent the food or beverages are made available to the general public is not subject to the deduction limitations in paragraph (a) of this section. If a taxpayer provides food or beverages to employees, this exception applies to the entire amount of expenses for those food or beverages if the same type of food or beverages is provided to, and are primarily consumed by, the general public.

(B) *Examples.* The following examples illustrate the application of this paragraph (c)(2)(iv). In each example, assume that the food and beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business.

(*1*) *Example 1.* Employer P is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by P's employees, potential buyers of the property, and other real estate agents. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations in paragraph (a) of this section if P determines that over 50 percent of the food and beverages are actually or reasonably estimated to be consumed by potential buyers and other real estate agents. If more than 50 percent of the food and beverages are not actually or reasonably estimated to be consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv). In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply to the expenses associated with the refreshments that are not excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

(*2*) *Example 2.* Employer Q is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Q's employees and customers, and Q reasonably estimates that more than 50 percent of the refreshments are consumed by customers. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations provided for in paragraph (a) of this section because the food and beverages are primarily consumed by customers. Thus, Q may deduct 100 percent of the food and beverage expenses.

(*3*) *Example 3.* Employer R operates a summer camp open to the general public for children and provides breakfast and lunch, as part of the fee to attend camp, both to camp counselors, who are employees, and to camp attendees, who are customers. There are 20 camp counselors and 100 camp attendees. The same type of meal is available to each counselor and attendee, and attendees consume more than 50 percent of the food and beverages. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the food and beverages are not subject to the deduction limitations in paragraph (a) of this section, because over 50 percent of the food and beverages are consumed by camp attendees and the food and beverages are therefore primarily consumed by the general public. Thus, R may deduct 100 percent of the food and beverage expenses.

(*4*) *Example 4.* Employer S provides food and beverages to its employees without charge at a company cafeteria on its premises. Occasionally, customers or other visitors also eat without charge in the cafeteria. The occasional consumption of food and beverages at the company cafeteria by customers and visitors is less than 50 percent of the total amount of food and beverages consumed at the cafeteria. Therefore, the food and beverages are not primarily consumed by the general public, and only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv). In addition, the limitations in section 274(k)(1) and paragraph (a)(1) of this section apply to the expenses associated with the food and beverages that are not excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

(v) *Goods or services sold to customers*—(A) *In general.* In accordance with section 274(e)(8), an expense paid or incurred for food or beverages, to the extent the food or beverages are sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the deduction limitations in paragraph (a) of this section. However, *money or money's worth* does not include payment through services provided. Under this paragraph (c)(2)(v), a restaurant or catering business may deduct 100 percent of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employer's restaurant or catering business. In addition, for purposes of this paragraph (c)(2)(v), the term *customer* includes anyone, including an employee of the taxpayer, who is sold food or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth.

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

Example. Employer T operates a restaurant. T provides food and beverages to its food service employees before, during, and after their shifts for no consideration. Under section 274(e)(8) and this paragraph (c)(2)(v), the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitation in paragraph (a) of this section because the restaurant sells food and beverages to customers in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, T may deduct 100 percent of the food and beverage expenses.

(d) *Applicability date.* This section applies for taxable years that begin on or after October 9, 2020.

[T.D. 9925, 85 FR 64035, Oct. 9, 2020]

§ 1.274–13 Disallowance of deductions for certain qualified transportation fringe expenditures.

(a) *In general.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code (Code) is allowed for any expense of any qualified transportation fringe as defined in paragraph (b)(1) of this section.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Qualified transportation fringe.* The term *qualified transportation fringe* means any of the following provided by an employer to an employee:

(i) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment (as described in sections 132(f)(1)(A) and 132(f)(5)(B));

(ii) Any transit pass (as described in sections 132(f)(1)(B) and 132(f)(5)(A)); or

(iii) Qualified parking (as described in sections 132(f)(1)(C) and 132(f)(5)(C)).

(2) *Employee.* The term *employee* means a common law employee or other statutory employee, such as an officer of a corporation, who is currently employed by the taxpayer. See §1.132–9 Q/A–5. Partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, and independent contractors are not employees of the taxpayer for purposes of this section. See §1.132–9 Q/A–24.

(3) *General public.* (i) *In general.* The term *general public* includes, but is not limited to, customers, clients, visitors, individuals delivering goods or services to the taxpayer, students of an educational institution, and patients of a health care facility. The term general public does not include individuals that are employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, or independent contractors of the taxpayer. Also, an exclusive list of guests of a taxpayer is not the general public. Parking spaces that are available to the general public but empty are treated as provided to the general public. Parking spaces that are used to park vehicles owned by the general public while the vehicles await repair or service by the taxpayer are also treated as provided to the general public.

(ii) *Multi-tenant building.* If a taxpayer owns or leases space in a multi-tenant building, the term *general public* includes employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, independent contractors, clients, or customers of unrelated tenants in the building.

(4) *Parking facility.* The term *parking facility* includes indoor and outdoor garages and other structures, as well as parking lots and other areas, where a taxpayer provides qualified parking (as defined in section 132(f)(5)(C)) to one or more of its employees. The term *parking facility* may include one or more parking facilities but does not include parking spaces on or near property used by an employee for residential purposes.

(5) *Geographic location.* The term *geographic location* means contiguous tracts or parcels of land owned or leased by the taxpayer. Two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

(6) *Total parking spaces.* The term *total parking spaces* means the total

number of parking spaces, or the taxpayer's portion thereof, in the parking facility.

(7) *Reserved employee spaces.* The term *reserved employee spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. Employee spaces in the parking facility, or portion thereof, may be exclusively reserved for employees by a variety of methods, including, but not limited to, specific signage (for example, "Employee Parking Only") or a separate facility or portion of a facility segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in *reserved employee spaces.*

(8) *Reserved nonemployee spaces.* The term *reserved nonemployee spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. Such parking spaces may include, but are not limited to, spaces reserved exclusively for visitors, customers, partners, sole proprietors, 2-percent shareholders of S corporations (as defined in section 1372(b)), vendor deliveries, and passenger loading/unloading. Nonemployee spaces in the parking facility, or portion thereof, may be exclusively reserved for nonemployees by a variety of methods, including, but not limited to, specific signage (for example, "Customer Parking Only") or a separate facility, or portion of a facility, segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in *reserved nonemployee spaces.*

(9) *Inventory/unusable spaces.* The term *inventory/unusable spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively used or reserved for inventoried vehicles, qualified nonpersonal use vehicles described in §1.274–5(k), or other fleet vehicles used in the taxpayer's business, or that are otherwise not usable for parking by employees or the general public. Examples of such parking spaces include, but are not limited to, parking spaces for vehicles that are intended to be sold or leased at a car dealership or car rental agency, parking spaces for vehicles owned by an electric utility used exclusively to maintain electric power lines, or parking spaces occupied by trash dumpsters (or similar property). Taxpayers may use any reasonable methodology to determine the number of inventory/unusable spaces in the parking facility. A reasonable methodology may include using the average of monthly inventory counts.

(10) *Available parking spaces.* The term *available parking spaces* means the total parking spaces, less reserved employee spaces and less inventory/unusable spaces, that are available to employees and the general public.

(11) *Primary use.* The term *primary use* means greater than 50 percent of actual or estimated usage of the available parking spaces in the parking facility.

(12) *Total parking expenses*—(i) *In general.* The term *total parking expenses* means all expenses of the taxpayer related to total parking spaces in a parking facility including, but not limited to, repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment (if not broken out separately). A taxpayer may use any reasonable methodology to allocate mixed parking expenses to a parking facility. A deduction for an allowance for depreciation on a parking facility owned by a taxpayer and used for parking by the taxpayer's employees is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not included in *total parking expenses* for purposes of this section. Expenses paid or incurred for nonparking facility property, including items related to property next to the parking facility, such as landscaping or lighting, also are not included in *total parking expenses.*

(ii) *Optional rule for allocating certain mixed parking expenses.* A taxpayer may choose to allocate 5 percent of any the following mixed parking expenses to a parking facility: Lease or rental agreement expenses, property taxes, interest expense, and expenses for utilities and insurance.

(13) *Mixed parking expense.* The term *mixed parking expense* means a single expense amount paid or incurred by a

taxpayer that includes both parking facility and nonparking facility expenses for a property that a taxpayer owns or leases.

(14) *Peak demand period*—(i) *In general.* The term *peak demand period* refers to the period of time on a typical business day during the taxable year when the greatest number of the taxpayer's employees are utilizing parking spaces in the taxpayer's parking facility. If a taxpayer's employees work in shifts, the *peak demand period* would take into account the shift during which the largest number of employees park in the taxpayer's parking facility. However, a brief transition period during which two shifts overlap in their use of parking spaces, as one shift of employees is getting ready to leave and the next shift is reporting to work, may be disregarded. Taxpayers may use any reasonable methodology to determine the total number of spaces used by employees during the *peak demand period* on a typical business day. A reasonable methodology may include periodic inspections or employee surveys.

(ii) *Optional rule for federally declared disasters.* If a taxpayer owns or leases a parking facility that is located in a federally declared disaster area, as defined in section 165(i)(5), the taxpayer may choose to identify a typical business day for the taxable year in which the disaster occurred by reference to a typical business day in that taxable year prior to the date that the taxpayer's operations were impacted by the federally declared disaster. Alternatively, a taxpayer may choose to identify a typical business day during the month(s) of the taxable year in which the disaster occurred by reference to a typical business day during the same month(s) of the taxable year immediately preceding the taxable year in which the disaster first occurred. For purposes of applying the optional rule for federally declared disasters, the taxable year in which the disaster occurs is determined without regard to whether an election under section 165(i) is made with respect to the disaster.

(c) *Optional aggregation rule for calculating total parking spaces; taxpayer owned or leased parking facilities.* For purposes of determining total parking spaces in calculating the disallowance of deductions for qualified transportation fringe parking expenses under the general rule in paragraph (d)(2)(i) of this section, the primary use methodology in paragraph (d)(2)(ii)(B) of this section, or the cost per space methodology in paragraph (d)(2)(ii)(C) of this section, a taxpayer that owns or leases more than one parking facility in a single geographic location may aggregate the number of spaces in those parking facilities. For example, parking spaces at an office park or an industrial complex in the geographic location may be aggregated. However, a taxpayer may not aggregate parking spaces in parking facilities that are in different geographic locations. A taxpayer that chooses to aggregate its parking spaces under this paragraph (c) must determine its total parking expenses, including the allocation of mixed parking expenses, as if the aggregated parking spaces constitute one parking facility.

(d) *Calculation of disallowance of deductions for qualified transportation fringe expenses*—(1) *Taxpayer pays a third party for parking qualified transportation fringe.* If a taxpayer pays a third party an amount for its employees' parking qualified transportation fringe, the section 274(a)(4) disallowance generally is calculated as the taxpayer's total annual cost of employee parking qualified transportation fringes paid to the third party.

(2) *Taxpayer provides parking qualified transportation fringe at a parking facility it owns or leases.* If a taxpayer owns or leases all or a portion of one or more parking facilities where its employees park, the section 274(a)(4) disallowance may be calculated using the general rule in paragraph (d)(2)(i) of this section or any of the simplified methodologies in paragraph (d)(2)(ii) of this section. A taxpayer may choose to use the general rule or any of the following methodologies for each taxable year and for each parking facility.

(i) *General rule.* A taxpayer that uses the general rule in this paragraph (d)(2)(i) must calculate the disallowance of deductions for qualified transportation fringe parking expenses for each employee receiving the qualified transportation fringe based on a reasonable interpretation of section 274(a)(4). A taxpayer that uses the general rule in this paragraph (d)(2)(i) may use the aggregation rule in paragraph (c) of this section for determining total parking spaces. An interpretation of section 274(a)(4) is not reasonable unless the taxpayer applies the following rules when calculating the disallowance under this paragraph (d)(2)(i).

(A) *A taxpayer must not use value to determine expense.* A taxpayer may not use the value of employee parking to determine expenses allocable to employee parking that is either owned or leased by the taxpayer because section 274(a)(4) disallows a deduction for the expense of providing a qualified transportation fringe, regardless of its value.

(B) *A taxpayer must not deduct expenses related to reserved employee spaces.* A taxpayer must determine the allocable portion of total parking expenses that relate to any reserved employee spaces. No deduction is allowed for the parking expenses that relate to reserved employee spaces.

(C) *A taxpayer must not improperly apply the exception for qualified parking made available to the public.* A taxpayer must not improperly apply the exception in section 274(e)(7) or paragraph (e)(2)(ii) of this section to parking facilities, for example, by treating a parking facility regularly used by employees as available to the general public merely because the general public has access to the parking facility.

(ii) *Additional simplified methodologies.* Instead of using the general rule in paragraph (d)(2)(i) of this section for a taxpayer owned or leased parking facility, a taxpayer may use a simplified methodology under paragraph (d)(2)(ii)(A), (B), or (C) of this section.

(A) *Qualified parking limit methodology.* A taxpayer that uses the qualified parking limit methodology in this paragraph (d)(2)(ii)(A) must calculate the disallowance of deductions for qualified transportation fringe parking expenses by multiplying the total number of spaces used by employees during the peak demand period, or the total number of taxpayer's employees, by the section 132(f)(2) monthly per employee limitation on exclusion (adjusted for inflation), for each month in the taxable year. The result is the amount of the taxpayer's expenses that are disallowed under section 274(a)(4). In applying this methodology, a taxpayer calculates the disallowed amount as required under this paragraph (d)(2)(ii)(A), regardless of the actual amount of the taxpayer's total parking expenses. This methodology may be used only if the taxpayer includes the value of the qualified transportation fringe in excess of the sum of the amount, if any, paid by the employee for the qualified transportation fringe and the applicable statutory monthly limit in section 132(f)(2) as compensation paid to the employee under chapter 1 of the Code (chapter 1) and as wages to the employee for purposes of withholding under chapter 24 of the Code (chapter 24), relating to collection of Federal income tax at source on wages. In addition, the exception to the disallowance for amounts treated as employee compensation provided for in section 274(e)(2) and in paragraph (e)(2)(i) of this section cannot be applied to reduce a section 274(a)(4) disallowance calculated using this methodology. A taxpayer using this methodology may not use the aggregation rule in paragraph (c) of this section.

(B) *Primary use methodology.* A taxpayer that uses the primary use methodology in this paragraph (d)(2)(ii)(B) must use the following four-step methodology to calculate the disallowance of deductions for qualified transportation fringe parking expenses for each parking facility for which the taxpayer uses the primary use methodology. A taxpayer using this methodology may use the aggregation rule in paragraph (c) of this section for determining total parking spaces.

(*1*) *Step 1—Calculate the disallowance for reserved employee spaces.* A taxpayer must identify the total parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. The taxpayer must then determine the percentage of reserved employee spaces in relation to total parking spaces and multiply that percentage by the taxpayer's total parking expenses for the parking facility. The product is the amount of the deduction for total parking expenses that is disallowed under section 274(a)(4) for reserved employee spaces. There is no disallowance for reserved employee spaces if the following conditions are met:

(*i*) The primary use (as defined in paragraphs (b)(11) and (d)(2)(ii)(B)(*2*) of this section) of the available parking spaces is to provide parking to the general public;

(*ii*) There are five or fewer reserved employee spaces in the parking facility; and

(*iii*) The reserved employee spaces are 5 percent or less of the total parking spaces.

(*2*) *Step 2—Determine the primary use of available parking spaces.* A taxpayer must identify the available parking spaces in the parking facility and determine whether their primary use is to provide parking to the general public. If the primary use of the available parking spaces in the parking facility is to provide parking to the general public, then total parking expenses allocable to available parking spaces at the parking facility are excepted from the section 274(a)(4) disallowance by the general public exception under section 274(e)(7) and paragraph (e)(2)(ii) of this section. Primary use of available parking spaces is based on the number of available parking spaces used by employees during the peak demand period.

(*3*) *Step 3—Calculate the allowance for reserved nonemployee spaces.* If the primary use of a taxpayer's available parking spaces is not to provide parking to the general public, the taxpayer must identify the number of available parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. A taxpayer that has no reserved nonemployee spaces may proceed to Step 4 in paragraph (d)(2)(ii)(B)(*4*) of this section. If the taxpayer has reserved nonemployee spaces, it may determine the percentage of reserved nonemployee spaces in relation to remaining total parking spaces and multiply that percentage by the taxpayer's remaining total parking expenses. The product is the amount of the deduction for remaining total parking expenses that is not disallowed because the spaces are not available for employee parking.

(*4*) *Step 4—Determine remaining use of available parking spaces and allocable expenses.* If a taxpayer completes Steps 1—3 in paragraph (d)(2)(ii)(B) of this section and has any remaining total parking expenses not specifically categorized as deductible or nondeductible, the taxpayer must reasonably allocate such expenses by determining the total number of available parking spaces used by employees during the peak demand period.

(C) *Cost per space methodology.* A taxpayer using the cost per space methodology in this paragraph (d)(2)(ii)(C) must calculate the disallowance of deductions for qualified transportation fringe parking expenses by multiplying the cost per space by the number of total parking spaces used by employees during the peak demand period. The product is the amount of the deduction for total parking expenses that is disallowed under section 274(a)(4). A taxpayer may calculate cost per space by dividing total parking expenses by total parking spaces. This calculation may be performed on a monthly basis. A taxpayer using this methodology may use the aggregation rule in paragraph (c) of this section for determining total parking spaces.

(3) *Expenses for transportation in a commuter highway vehicle or transit pass.* If a taxpayer pays a third party an amount for its employees' commuter highway vehicle or a transit pass qualified transportation fringe, the section 274(a)(4) disallowance generally is equal to the taxpayer's total annual cost of employee commuter highway vehicle or a transit pass qualified transportation fringes paid to the third party. If a taxpayer provides transportation in a commuter highway vehicle or transit pass qualified transportation fringes in kind directly to its employees, the taxpayer must calculate the disallowance of deductions for expenses for such fringes based on a reasonable interpretation of section 274(a)(4). However, a taxpayer may not use the value of the qualified commuter highway vehicle or transit pass fringe to the employee to determine expenses allocable to such fringe because section 274(a)(4) disallows a deduction for the expense of providing a qualified transportation

fringe, regardless of its value to the employee.

(e) *Specific exceptions to disallowance of deduction for qualified transportation fringe expenses*—(1) *In general.* The provisions of section 274(a)(4) and paragraph (a) of this section (imposing limitations on deductions for qualified transportation fringe expenses) are not applicable in the case of expenditures set forth in paragraph (e)(2) of this section. Such expenditures are deductible to the extent allowable under chapter 1 of the Code. This paragraph (e) cannot be construed to affect whether a deduction under section 162 or 212 is allowed or allowable. The fact that an expenditure is not covered by a specific exception provided for in this paragraph (e) is not determinative of whether a deduction for the expenditure is disallowed under section 274(a)(4) and paragraph (a) of this section.

(2) *Exceptions to disallowance.* The expenditures referred to in paragraph (e)(1) of this section are set forth in paragraphs (e)(2)(i) through (iii) of this section.

(i) *Certain qualified transportation fringe expenses treated as compensation*—(A) *Expenses includible in income of persons who are employees and are not specified individuals.* In accordance with section 274(e)(2)(A), and except as provided in paragraph (e)(2)(i)(C) of this section, an expense paid or incurred by a taxpayer for a qualified transportation fringe, if an employee who is not a specified individual is the recipient of the qualified transportation fringe, is not subject to the disallowance of deductions provided for in paragraph (a) of this section to the extent that the taxpayer—

(*1*) Properly treats the expense relating to the recipient of the qualified transportation fringe as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24; and

(*2*) Treats the proper amount as compensation to the employee under §1.61–21.

(B) *Specified Individuals.* In accordance with section 274(e)(2)(B), in the case of a specified individual (as defined in section 274(e)(2)(B)(ii)), the disallowance of deductions provided for in paragraph (a) of this section does not apply to an expense for a qualified transportation fringe of the specified individual to the extent that the amount of the expense does not exceed the sum of—

(*1*) The amount treated as compensation to the specified individual under chapter 1 and as wages to the specified individual for purposes of chapter 24; and

(*2*) Any amount the specified individual reimburses the taxpayer.

(C) *Expenses for which an amount is excluded from income or is less than the proper amount.* Notwithstanding paragraph (e)(2)(i)(A) of this section, in the case of an expense paid or incurred by a taxpayer for a qualified transportation fringe for which an amount is wholly or partially excluded from a recipient's income under subtitle A of the Code (other than because the amount is reimbursed by the recipient), or for which an amount included in compensation and wages to an employee is less than the amount required to be included under §1.61–21, the disallowance of deductions provided for in paragraph (a) of this section does not apply to the extent that the amount of the expense does not exceed the sum of—

(*1*) The amount treated as compensation to the recipient under chapter 1 and as wages to the recipient for purposes of chapter 24; and

(*2*) Any amount the recipient reimburses the taxpayer.

(ii) *Expenses for transportation in a commuter highway vehicle, transit pass, or parking made available to the public.* Under section 274(e)(7) and this paragraph (e)(2)(ii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe is not subject to the disallowance of deductions provided for in paragraph (a) of this section to the extent that such transportation, transit pass, or parking is made available to the general public. With respect to parking, this exception applies to the entire amount of the taxpayer's parking expense, less any expenses specifically attributable to employees (for example, expenses allocable to reserved employee spaces), if the primary use of the parking is by the general public. If the primary use of the parking is not by the general public, this exception applies only to the costs attributable to the parking used by the general public.

(iii) *Expenses for transportation in a commuter highway vehicle, transit pass, or parking sold to customers.* Under section 274(e)(8) and this paragraph (e)(2)(iii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe to the extent such transportation, transit pass, or parking is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the disallowance of deductions provided for in paragraph (a) of this section. For purposes of this paragraph (e)(2)(iii), the term *customer* includes an employee of the taxpayer who purchases transportation in a commuter highway vehicle, a transit pass, or parking in a bona fide transaction for an adequate and full consideration in money or money's worth. If in a bona fide transaction, the adequate and full consideration for qualified parking is zero, the exception in this paragraph (e)(2)(iii) applies even though the taxpayer does not actually sell the parking to its employees. To apply the exception in this case, the taxpayer bears the burden of proving that the fair market value of the qualified parking is zero. However, solely for purposes of this paragraph (e)(2)(iii), a taxpayer will be treated as satisfying this burden if the qualified parking is provided in a rural, industrial, or remote area in which no commercial parking is available and an individual other than an employee ordinarily would not pay to park in the parking facility.

(f) *Examples.* The following examples illustrate the provisions of this section related to parking expenses for qualified transportation fringes. For each example, unless otherwise stated, assume the parking expenses are otherwise deductible expenses paid or incurred during the 2020 taxable year; all or some portion of the expenses relate to a qualified transportation fringe under section 132(f); the section 132(f)(2) monthly per employee limitation on an employee's exclusion is $270; the fair market value of the qualified parking is not $0; all taxpayers are calendar-year taxpayers; and the length of the 2020 taxable year is 12 months.

(1) *Example 1.* Taxpayer A pays B, a third party who owns a parking garage adjacent to A's place of business, $100 per month per parking space for each of A's 10 employees to park in B's garage, or $12,000 for parking in 2020 (($100 × 10) × 12 = $12,000). The $100 per month paid for each of A's 10 employees for parking is excludible from the employees' gross income under section 132(a)(5), and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable. Thus, the entire $12,000 is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

(2) *Example 2.* (i) Assume the same facts as in paragraph (f)(1) of this section (*Example 1*), except A pays B $300 per month for each parking space, or $36,000 for parking for 2020 (($300 × 10) × 12 = $36,000). Of the $300 per month paid for parking for each of 10 employees, $270 is excludible under section 132(a)(5) for 2020 and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. A properly treats the excess amount of $30 ($300 − $270) per employee per month as compensation and wages. Thus, $32,400 (($270 × 10) × 12 = $32,400) is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

(ii) The excess amount of $30 per employee per month is not excludible under section 132(a)(5). As a result, the exceptions in section 274(e)(2) and paragraph (e)(2)(i) of this section are applicable to this amount. Thus, $3,600 ($36,000 − $32,400 = $3,600) is not subject to the section 274(a)(4) disallowance and remains deductible.

(3) *Example 3.* (i) Taxpayer C leases from a third party a parking facility that includes 200 parking spaces at a rate of $500 per space, per month in 2020. C's annual lease payment for the parking spaces is $1,200,000 ((200 × $500) × 12 = $1,200,000). The number of available parking spaces used by C's employees during the peak demand period is 200.

(ii) C uses the qualified parking limit methodology described in paragraph (d)(2)(ii)(A) of this section to determine the disallowance under section 274(a)(4). Under this methodology, the section 274(a)(4) disallowance is calculated by multiplying the number of available parking spaces used by employees during the peak demand period, 200, the section 132(f)(2) monthly per employee limitation on exclusion, $270, and 12, the number of months in the applicable taxable year. The amount subject to the section 274(a)(4) disallowance is $648,000 (200 × $270 × 12 = $648,000). This amount is excludible from C's employees' gross incomes under section 132(a)(5) and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. The excess $552,000 ($1,200,000 − $648,000) for which C is not disallowed a deduction under 274(a)(4) is included in C's employees' gross incomes because it exceeds the section 132(f)(2) monthly per employee limitation on exclusion.

(4) *Example 4*. (i) *Facts*. Taxpayer D, a big box retailer, owns a surface parking facility adjacent to its store. D incurs $10,000 of total parking expenses for its store in the 2020 taxable year. D's parking facility has 510 spaces that are used by its customers, employees, and its fleet vehicles. None of D's parking spaces are reserved. The number of available parking spaces used by D's employees during the peak demand period is 50. Approximately 30 nonreserved parking spaces are empty during D's peak demand period. D's fleet vehicles occupy 10 parking spaces.

(ii) *Methodology*. D uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1*. Because none of D's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(*1*) of this section.

(iv) *Step 2*. D's number of available parking spaces is the total parking spaces reduced by the number of reserved employee spaces and inventory/unusable spaces or 500 (510 − 0 − 10 = 500). The number of available parking spaces used by D's employees during the peak demand period is 50. Of the 500 available parking spaces, 450 are used to provide parking to the general public, including the 30 empty nonreserved parking spaces that are treated as provided to the general public. The primary use of D's available parking spaces is to provide parking to the general public because 90% (450/500 = 90%) of the available parking spaces are used by the general public under paragraph (d)(2)(ii)(B)(*2*) of this section. Because the primary use of the available parking spaces is to provide parking to the general public, the exception in section 274(e)(7) and paragraph (e)(2)(ii) of this section applies and none of the $10,000 of total parking expenses is subject to the section 274(a)(4) disallowance.

(5) *Example 5*. (i) *Facts*. Taxpayer E, a manufacturer, owns a surface parking facility adjacent to its plant. E incurs $10,000 of total parking expenses in 2020. E's parking facility has 500 spaces that are used by its visitors and employees. E reserves 25 of these spaces for nonemployee visitors. The number of available parking spaces used by E's employees during the peak demand period is 400.

(ii) *Methodology*. E uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1*. Because none of E's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(*1*) of this section.

(iv) *Step 2*. The primary use of E's parking facility is not to provide parking to the general public because 80% (400/500 = 80%) of the available parking spaces are used by its employees. Thus, expenses allocable to those spaces are not excepted from the section 274(a) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(*2*) of this section.

(v) *Step 3*. Because 5% (25/500 = 5%) of E's available parking spaces are reserved nonemployee spaces, up to $9,500 ($10,000 × 95% = $9,500) of E's total parking expenses are subject to the section

274(a)(4) disallowance under this step as provided in paragraph (d)(2)(ii)(B)(*3*) of this section. The remaining $500 ($10,000 × 5% = $500) of expenses allocable to reserved nonemployee spaces is excepted from the section 274(a) disallowance and continues to be deductible.

(vi) *Step 4.* E must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by E's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(*4*) of this section.

(6) *Example 6.* (i) *Facts.* Taxpayer F, a manufacturer, owns a surface parking facility adjacent to its plant. F incurs $10,000 of total parking expenses in 2020. F's parking facility has 500 spaces that are used by its visitors and employees. F reserves 50 spaces for management. All other employees park in nonreserved spaces in F's parking facility; the number of available parking spaces used by F's employees during the peak demand period is 400. Additionally, F reserves 10 spaces for nonemployee visitors.

(ii) *Methodology.* F uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because F reserved 50 spaces for management, $1,000 ((50/500) × $10,000 = $1,000) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(*1*) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.

(iv) *Step 2.* The primary use of the remainder of F's parking facility is not to provide parking to the general public because 89% (400/450 = 89%) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(*2*) of this section.

(v) *Step 3.* Because 2% (10/450 = 2.22%) of F's available parking spaces are reserved nonemployee spaces, the $180 allocable to those spaces (($10,000 − $1,000) × 2%) is not subject to the section 274(a)(4) disallowance and continues to be deductible under paragraph (d)(2)(ii)(B)(*3*) of this section.

(vi) *Step 4.* F must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by F's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(*4*) of this section.

(7) *Example 7.* (i) *Facts.* Taxpayer G, a financial services institution, owns a multi-level parking garage adjacent to its office building. G incurs $10,000 of total parking expenses in 2020. G's parking garage has 1,000 spaces that are used by its visitors and employees. However, one floor of the parking garage is segregated by an electronic barrier that can only be accessed with a card provided by G to its employees. The segregated parking floor contains 100 spaces. The other floors of the parking garage are not used by employees for parking during the peak demand period.

(ii) *Methodology.* G uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because G has 100 reserved spaces for employees, $1,000 ((100/1,000) × $10,000 = $1,000) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraph (d)(2)(ii)(B)(*1*) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.

(iv) *Step 2.* The primary use of the available parking spaces in G's parking facility is to provide parking to the general public because 100% (900/900 = 100%) of the available parking spaces are used by the public. Thus, expenses allocable to those spaces, $9,000, are excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(*2*).

(8) *Example 8*. (i) *Facts*. Taxpayer H, an accounting firm, leases a parking facility adjacent to its office building. H incurs $10,000 of total parking expenses related to the lease payments in 2020. H's leased parking facility has 100 spaces that are used by its clients and employees. None of the parking spaces are reserved. The number of available parking spaces used by H's employees during the peak demand period is 60.

(ii) *Methodology*. H uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1*. Because none of H's leased parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(*1*) of this section.

(iv) *Step 2*. The primary use of H's leased parking facility under paragraph (d)(2)(ii)(B)(*2*) of this section is not to provide parking to the general public because 60% (60/100 = 60%) of the lot is used by its employees. Thus, H may not utilize the general public exception from the section 274(a)(4) disallowance provided by section 274(e)(7) and paragraph (e)(2)(ii) of this section.

(v) *Step 3*. Because none of H's parking spaces are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(*3*) of this section.

(vi) *Step 4*. H must reasonably determine the use of the parking spaces and the related expenses allocable to employee parking. Because the number of available parking spaces used by H's employees during the peak demand period is 60, H reasonably determines that 60% (60/100 = 60%) of H's total parking expenses or $6,000 ($\$10,000 \times 60\% = \$6,000$) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(*4*) of this section.

(9) *Example 9*. (i) *Facts*. Taxpayer I, a large manufacturer, owns multiple parking facilities adjacent to its manufacturing plant, warehouse, and office building at its complex in the city of X. All of I's tracts or parcels of land at its complex in city X are located in a single geographic location. I owns parking facilities in other cities. I incurs $50,000 of total parking expenses related to the parking facilities at its complex in city X in 2020. I's parking facilities at its complex in city X have 10,000 total parking spaces that are used by its visitors and employees of which 500 are reserved for management. All other spaces at parking facilities in I's complex in city X are nonreserved. The number of nonreserved spaces used by I's employees other than management during the peak demand period at I's parking facilities in city X is 8,000.

(ii) *Methodology*. I uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). I chooses to apply the aggregation rule in paragraph (c) of this section to aggregate all parking facilities in the geographic location that comprises its complex in city X. However, I may not aggregate parking facilities in other cities with its parking facilities in city X because they are in different geographic locations.

(iii) *Step 1*. Because 500 spaces are reserved for management, $2,500 ($(500/10{,}000) \times \$50{,}000 = \$2{,}500$) is the amount of total parking expenses that is nondeductible for reserved employee spaces for I's parking facilities in city X under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(*1*) of this section.

(iv) *Step 2*. The primary use of the remainder of I's parking facility is not to provide parking to the general public because 84% (8,000/9,500 = 84%) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4) disallowance by section 274(e)(7) or paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(*2*) of this section.

(v) *Step 3*. Because none of I's parking spaces in its parking facilities in city X are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(*3*) of this section.

(vi) *Step 4*. I must reasonably determine the use of the remaining parking spaces and the related expenses allocable to employee parking for its parking facilities in city X. Because the number of available parking spaces used by I's employees during the peak demand period in city X during an average workday is 8,000, I reasonably determines that 84.2% (8,000/9,500 = 84.2%) of I's remaining parking expense or $39,900 (($50,000 − $2,500) × 84% = $39,900) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(*4*) of this section.

(10) *Example 10.* (i) Taxpayer J, a manufacturer, owns a parking facility and incurs the following mixed parking expenses (along with other parking expenses): Property taxes, utilities, insurance, security expenses, and snow removal expenses. In accordance with paragraph (b)(12)(i) and (ii) of this section, J determines its total parking expenses by allocating 5% of its property tax, utilities, and insurance expenses to its parking facility. J uses a reasonable methodology to allocate to its parking facility an applicable portion of its security and snow removal expenses. J determines that it incurred $100,000 of total parking expenses in 2020. J's parking facility has 500 spaces that are used by its visitors and employees. The number of total parking spaces used by J's employees during the peak demand period is 475.

(ii) J uses the cost per space methodology described in paragraph (d)(2)(ii)(C) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). Under this methodology, J multiplies the cost per space by the number of total parking spaces used by J's employees during the peak demand period. J calculates the cost per space by dividing total parking expenses by the number of total parking spaces ($100,000/500 = $200). J determines that $95,000 ($200 × 475 = $95,000) of J's total parking expenses is subject to the section 274(a)(4) disallowance and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable.

(11) *Example 11.* Taxpayer K operates an industrial plant with a parking facility in a rural area in which no commercial parking is available. K provides qualified parking at the plant to its employees free of charge. Further, an individual other than an employee ordinarily would not consider paying any amount to park in the plant's parking facility. Although K does not charge its employees for the qualified parking, the exception in section 274(e)(8) and this paragraph (e)(3)(iii) will apply to K's total parking expenses if in a bona fide transaction, the adequate and full consideration for the qualified parking is zero. In order to treat the adequate and full consideration as zero, K bears the burden of proving that the parking has no objective value. K is treated as satisfying this burden because the parking is provided in a rural area in which no commercial parking is available and in which an individual other than an employee ordinarily would not consider paying any amount to park in the parking facility. Therefore, the exception in paragraph (e)(2)(iii) of this section applies to K's total parking expenses and a deduction for the expenses is not disallowed by reason of section 274(a)(4).

(g) *Applicability date.* This section applies to taxable years beginning on or after December 16, 2020. However, taxpayers may choose to apply §1.274–13(b)(14)(ii) to taxable years ending after December 31, 2019.

[T.D. 9939, 85 FR 81402, Dec. 16, 2020, as amended by 86 FR 22345, Apr. 28, 2021]

§ 1.274–14 Disallowance of deductions for certain transportation and commuting benefit expenditures.

(a) *General rule.* Except as provided in this section, no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment. The disallowance is not subject to the exceptions provided in section 274(e). The disallowance applies regardless of whether the travel between the employee's residence and place of employment includes more than one mode of transportation, and regardless of whether the taxpayer provides, or pays or reimburses the employee for, all modes of transportation used during the trip. For example, the disallowance applies if an employee drives a personal vehicle to a location where a different mode of transportation is used to complete the trip to the place of employment, even though the taxpayer may not incur any expense for the portion of travel in the employee's personal vehicle. The rules in section 274(l) and this section do not apply to business expenses under section 162(a)(2) paid or incurred while traveling away from home. The rules in section 274(l) and this section also do not apply to any expenditure for any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer. All qualified transportation fringe expenses are required to be analyzed under section 274(a)(4) and §1.274–13.

(b) *Exception.* The disallowance for the deduction for expenses incurred for providing any transportation or commuting in paragraph (a) of this section does not apply if the transportation or commuting expense is necessary for ensuring the safety of the employee. The transportation or commuting expense is necessary for ensuring the safety of the employee if unsafe conditions, as described in §1.61–21(k)(5), exist for the employee.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Employee.* The term *employee* means an employee of the taxpayer as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules).

(2) *Residence.* The term *residence* means a residence as defined in §1.121–1(b)(1). An employee's residence is not limited to the employee's principal residence.

(3) *Place of employment.* The term *place of employment* means the employee's regular or principal (if more than one regular) place of business. An employee's place of employment does not include temporary or occasional places of employment. An employee must have at least one regular or principal place of business.

(d) *Applicability date.* This section applies to taxable years beginning on or after December 16, 2020.

[T.D. 9939, 85 FR 81408, Dec. 16, 2020]

§ 1.275–1 Deduction denied in case of certain taxes.

For description of the taxes for which a deduction is denied under section 275, see paragraphs (a), (b), (c), (e), and (h) of §1.164–2.

[T.D. 6780, 29 FR 18148, Dec. 22, 1964, as amended by T.D. 7767, 46 FR 11264, Feb. 6, 1981]

§ 1.276–1 Disallowance of deductions for certain indirect contributions to political parties.

(a) *In general.* Notwithstanding any other provision of law, no deduction shall be allowed for income tax purposes in respect of any amount paid or incurred after March 15, 1966, in a taxable year of the taxpayer beginning after December 31, 1965, for any expenditure to which paragraph (b)(1), (c), (d), or (e) of this section is applicable. Section 276 is a disallowance provision exclusively and does not make deductible any expenses which are not otherwise allowed under the Code. For certain other rules in respect of deductions for expenditures for political purposes, see §§1.162–15(b), 1.162–20, and 1.271–1.

(b) *Advertising in convention program*—(1) *General rule.* (i) Except as provided in subparagraph (2) of this paragraph, no deduction shall be allowed for an expenditure for advertising in a convention program of a political party. For purposes of this subparagraph it is immaterial who publishes the convention program or to whose use the proceeds of the program inure (or are intended to inure). A convention program is any written publication (as defined in paragraph (c) of this section) which is distributed or displayed in connection with or at a political convention, conclave, or meeting. Under certain conditions payments to a committee organized for the purpose of bringing a political convention to an area are deductible under paragraph (b) of §1.162–15. This rule is not affected by the provisions of this section. For example, such payments may be deductible notwithstanding the fact that the committee purchases from a political party the right to publish a pamphlet in connection with a convention and that the deduction of costs of advertising in the pamphlet is prohibited under this section.

(ii) The application of the provisions of this subparagraph may be illustrated by the following example:

Example. M Corporation publishes the convention program of the Y political party for a convention not described in subparagraph (2) of this paragraph. The corporation makes no payment of any kind to or on behalf of the party or any of its candidates and no part of the proceeds of the publication and sale of the program inures directly or indirectly to the benefit of any political party or candidate. P Corporation purchases an advertisement in the program. P Corporation may not deduct the cost of such advertisement.

(2) *Amounts paid or incurred on or after January 1, 1968, for advertising in programs of certain national political conventions.* (i) Subject to the limitations in subdivision (ii) of this subparagraph, a deduction may be allowed for any amount paid or incurred on or after January 1, 1968, for advertising in a convention program of a political party distributed in connection with a convention held for the purpose of nominating candidates for the offices of President and Vice President of the United States, if the proceeds from the program are actually used solely to defray the costs of conducting the convention (or are set aside for such use at the next convention of the party held for such purpose) and if the amount paid or incurred for the advertising is reasonable. If such amount is not reasonable or if any part of the proceeds is used for a purpose other than that of defraying such convention costs, no part of the amount is deductible. Whether or not an amount is reasonable shall be determined in light of the business the taxpayer may expect to receive either directly as a result of the advertising or as a result of the convention being held in an area in which the taxpayer has a principal place of business. For these purposes, an amount paid or incurred for advertising will not be considered as reasonable if it is greater than the amount which would be paid for comparable advertising in a comparable convention program of a nonpolitical organization. Institutional advertising (e.g., advertising of a type not designed to sell specific goods or services to persons attending the convention) is not advertising which may be expected to result directly in business for the taxpayer sufficient to make the expenditures reasonable. Accordingly, an amount spent for institutional advertising in a convention program may be deductible only if the taxpayer has a principal place of business in the area where the convention is held. An official statement made by a political party after a convention as to the use made of the proceeds from its convention program shall constitute prima facie evidence of such use.

(ii) No deduction may be taken for any amount described in this subparagraph which is not otherwise allowable as a deduction under section 162, relating to trade or business expenses. Therefore, in order for any such amount to be deductible, it must first satisfy the requirements of section 162, and, in addition, it must also satisfy the more restrictive requirements of this subparagraph.

(c) *Advertising in publication other than convention program.* No deduction shall be allowed for an expenditure for advertising in any publication other than a convention program if any part of the proceeds of such publication directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a publication includes a book, magazine, pamphlet, brochure, flier, almanac, newspaper, newsletter, handbill, billboard, menu, sign, scorecard, program, announcement, radio or television program or announcement, or any similar means of communication. For the definition of inurement of proceeds to a political party or a political candidate, see paragraph (f)(3) of this section.

(d) *Admission to dinner or program.* No deduction shall be allowed for an expenditure for admission to any dinner or program, if any part of the proceeds of such event directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate. For purposes of this paragraph, a dinner or program includes a gala, dance, ball, theatrical or film presentation, cocktail or other party, picnic, barbecue, sporting event, brunch, tea, supper, auction, bazaar, reading, speech, forum, lecture, fashion show, concert, opening, meeting, gathering, or any similar event. For the definition of inurement of proceeds to a political party or a political candidate and of admission to a dinner or program, see paragraph (f) of this section.

(e) *Admission to inaugural event.* (1) No deduction shall be allowed for an expenditure for admission to an inaugural ball, inaugural gala, inaugural parade, or inaugural concert, or to any similar event (such as a dinner or program, as defined in paragraph (d) of this section), in connection with the inauguration or installation in office of any official, or any equivalent event for an unsuccessful candidate, if the event is identified with a political party or a political candidate. For purposes of this paragraph, the sponsorship of the event and the use to which the proceeds of the event are or may be put are irrelevant, except insofar as they may tend to identify the event with a political party or a political candidate. For the definition of admission to an inaugural event, see paragraph (f)(4) of this section.

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

Example. An inaugural reception for A, a prominent member of Y party who has been recently elected judge of the municipal court of F city, is held with the proceeds going to the city treasury. The price of admission to such affair is not deductible.

(f) *Definitions*—(1) *Political party.* For purposes of this section the term *political party* has the same meaning as that provided for in paragraph (b)(1) of §1.271–1.

(2) *Political candidate.* For purposes of this section, the term *political candidate* is to be construed in accordance with the purpose of section 276 to deny tax deductions for certain expenditures which may be used directly or indirectly to finance political campaigns. The term includes a person who, at the time of the event or publication with respect to which the deduction is being sought, has been selected or nominated by a political party for any elective office. It also includes an individual who is generally believed, under the facts and circumstances at the time of the event or publication, by the persons making expenditures in connection therewith to be an individual who is or who in the reasonably foreseeable future will be seeking selection, nomination, or election to any public office. For purposes of the preceding sentence, the facts and circumstances to be considered include, but are not limited to, the purpose of the event or publication and the disposition to be made of the proceeds. In the absence of evidence to the contrary it shall be presumed that persons making expenditures in connection with an event or publication generally believe that an incumbent of an elective public office will run for reelection to his office or for election to some other public office.

(3) *Inurement of proceeds to political party or political candidate*—(i) *In general.* Subject to the special rules presented in subdivision (iii) of this subparagraph (relating to a political candidate), proceeds directly or indirectly inure to or for the use of a political party or a political candidate (*a*) if the party or candidate may order the disposition of any part of such proceeds, regardless of what use is actually made thereof, or (*b*) if any part of such proceeds is utilized by any person for the benefit of the party or candidate. These conditions are equally applicable in determining whether the proceeds are intended to inure. Accordingly, it is immaterial whether the event or publication operates at a loss if, had there been a profit, any part of the proceeds would have inured to or for the use of a political party or a political candidate. Moreover, it shall be presumed that where a dinner, program, or publication is sponsored by or identified with a political party or political candidate, the proceeds of such dinner, program, or publication directly or indirectly inure (or are intended to inure) to or for the use of the party or candidate. On the other hand, proceeds are not considered to directly or indirectly inure to the benefit of a political party or political candidate if the benefit derived is so remote as to be negligible or merely a coincidence of the relationship of a political candidate to a trade or business profiting from an expenditure of funds. For example, the proceeds of expenditures made by a taxpayer in the ordinary course of his

trade or business for advertising in a publication, such as a newspaper or magazine, are not considered as inuring to the benefit of a political party or political candidate merely because the publication endorses a particular political candidate or candidates of a particular political party, the publisher independently contributes to the support of a political party or candidate out of his own personal funds, or the principal stockholder of the publishing firm is a candidate for public office.

(ii) *Proceeds to political party.* If a political party may order the disposition of any part of the proceeds of a publication or event described in paragraph (c) or (d) of this section, such proceeds inure to the use of the party regardless of what the proceeds are to be used for or that their use is restricted to a particular purpose unrelated to the election of specific candidates for public office. Accordingly, where a political party holds a dinner for the purpose of raising funds to be used in a voter registration drive, voter education program, or nonprofit political research program, partisan or nonpartisan, the proceeds are considered to directly or indirectly inure to or for the use of the political party. Proceeds may inure to or for the use of a political party even though they are to be used for purposes which may not be directly related to any particular election (such as to pay office rent for its permanent quarters, salaries to permanent employees, or utilities charges, or to pay the cost of an event such as a dinner or program as defined in paragraph (d) of this section).

(iii) *Proceeds to political candidate.* Proceeds directly or indirectly inure (or are intended to inure) to or for the use of a political candidate if, in addition to meeting the conditions described in subdivision (i) of this subparagraph, (*a*) some part of the proceeds is or may be used directly or indirectly for the purpose of furthering his candidacy for selection, nomination, or election to any elective public office, and (*b*) they are not received by him in the ordinary course of a trade or business (other than the trade or business of holding public office). Proceeds may so inure whether or not the expenditure sought to be deducted was paid or incurred before the commencement of political activities with respect to the selection, nomination, or election referred to in (*a*) of this subdivision, or after such selection, nomination, or election has been made or has taken place. For example, proceeds of an event which may be used by an individual who, under the facts and circumstances at the time of the event, the persons making expenditures in connection therewith generally believe will in the reasonably foreseeable future run for a public office, and which may be used in furtherance of such individual's candidacy, generally will be deemed to inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering such individual's candidacy. Or, as another example, proceeds of an event occurring after an election, which may be used by a candidate in that election to repay loans incurred in directly or indirectly furthering his candidacy, or in reimbursement of expenses incurred in directly or indirectly furthering his candidacy, will be deemed to directly or indirectly inure (or to be intended to inure) to or for the use of a political candidate for the purpose of furthering his candidacy. For purposes of this subdivision, if the proceeds received by a candidate exceed substantially the fair market value of the goods furnished or services rendered by him, the proceeds are not received by the candidate in the ordinary course of his trade or business.

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

Example 1. Corporation O pays the Y political party $100,000 per annum for the right to publish the Y News, and retains the entire proceeds from the sale of the publication. Amounts paid or incurred for advertising in the Y News are not deductible because a part of the proceeds thereof indirectly inures to or for the use of a political party.

Example 2. The X political party holds a highly publicized ball honoring one of its active party members and admission tickets are offered to all. The guest of honor is a prominent national figure and a former incumbent of a high public office. The price of admission is designed to cover merely the cost of entertainment, food, and the ballroom, and all proceeds are paid to the hotel where the function is held, with the political party bearing the cost of any deficit. No deduction may be taken for the price of admission to the ball since the proceeds thereof inure to or for the use of a political party.

Example 3. Taxpayer A, engaged in a trade or business, purchases a number of tickets for admission to a fundraising affair held on behalf of political candidate B. The funds raised by this affair can be used by B for the purpose of furthering his candidacy. These expenditures are not deductible by A notwithstanding that B donates the proceeds of the affair to a charitable organization.

Example 4. A, an individual taxpayer who publishes a newspaper, is a candidate for elective public office. X Corporation advertises its products in A's newspaper, paying substantially more than the normal rate for such advertising. X Corporation may not deduct any portion of the cost of that advertising.

(4) *Admission to dinners, programs, inaugural events.* For purposes of this section, the cost of admission to a dinner, program, or inaugural event includes all charges, whether direct or indirect, for attendance and participation at such function. Thus, for example, amounts spent to be eligible for door prizes, for the privilege of sitting at the head table, or for transportation furnished as part of such an event, or any separate charges for food or drink, are amounts paid for admission.

[T.D. 6996, 34 FR 833, Jan. 18, 1969, as amended by T.D. 7010, 34 FR 7145, May 1, 1969]

§ 1.278–1 Capital expenditures incurred in planting and developing citrus and almond groves.

(a) *General rule.* (1)(i) Except as provided in subparagraph (2)(iii) of this paragraph and paragraph (b) of this section, there shall be charged to capital account any amount (allowable as a deduction without regard to section 278 or this section) which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof), and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted. For purposes of section 278 and this section, such an amount shall be considered as ''incurred'' in accordance with the taxpayer's regular tax accounting method used in reporting income and expenses connected with the citrus or almond grove operation. For purposes of this paragraph, the portion of a citrus or almond grove planted in 1 taxable year shall be treated separately from the portion of such grove planted in another taxable year. The provisions of section 278 and this section apply to taxable years beginning after December 31, 1969, in the case of a citrus grove, and to taxable years beginning after January 12, 1971, in the case of an almond grove.

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

Example 1. T, a fiscal year taxpayer plants a citrus grove 5 weeks before the close of his taxable year ending in 1971. T is required to capitalize any amount (allowable as a deduction without regard to section 278 or this section) attributable to the planting, cultivation, maintenance, or development of such grove until the close of his taxable year ending in 1974.

Example 2. Assume the same facts as in *Example 1,* except that T plants one portion of such grove 5 weeks before the close of his taxable year ending in 1971 and another portion of such grove at the beginning of his taxable year ending in 1972. The required capitalization period for expenses attributable to the first portion of such grove shall run until the close of T's taxable year ending in 1974. The required capitalization period for expenses attributable to the second portion of such grove shall run until the close of T's taxable year ending in 1975.

(2)(i) For purposes of section 278 and this section a *citrus grove* is defined as one or more trees of the rue family, often thorny and bearing large fruit with hard, usually thick peel and pulpy flesh, such as the orange, grapefruit, lemon, lime, citron, tangelo, and tangerine.

(ii) For purposes of section 278 and this section, an *almond grove* is defined as one or more trees of the species *Prunus amygdalus.*

(iii) An amount attributable to the cultivation, maintenance, or development of a citrus or almond grove (or part thereof) shall include, but shall not be limited to, the following developmental or cultural practices expenditures: Irrigation, cultivation, pruning, fertilizing, management fees, frost protection, spraying, and upkeep of the citrus or almond grove. The provisions of section 278(a) and this paragraph shall apply to expenditures for fertilizer and related materials notwithstanding the provisions of section 180, but shall not apply to expenditures attributable to real estate taxes or interest, to soil and water conservation expenditures allowable as a deduction under section 175, or to expenditures for clearing land allowable as a deduction under section 182. Further, the provisions of section 278(a) and this paragraph apply only to expenditures allowable as deductions without regard to section 278 and have no application to expenditures otherwise chargeable to capital account, such as the cost of the land and preparatory expenditures incurred in connection with the citrus or almond grove.

(iv) For purposes of section 278 and this section, a citrus or almond tree shall be considered to be ''planted'' on the date on which the tree is placed in the permanent grove from which production is expected.

(3)(i) The period during which expenditures described in section 278(a) and this paragraph are required to be capitalized shall, once determined, be unaffected by a sale or other disposition of the citrus or almond grove. Such period shall, in all cases, be computed by reference to the taxable years of the owner of the grove at the time that the citrus or almond trees were planted. Therefore, if a citrus or almond grove subject to the provisions of section 278 or this paragraph is sold or otherwise transferred by the original owner of the grove before the close of his fourth taxable year beginning with the taxable year in which the trees were planted, expenditures described in section 278(a) or this paragraph made by the purchaser or other transferee of the citrus or almond grove from the date of his acquisition until the close of the original holder's fourth such taxable year are required to be capitalized.

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

Example. T, a fiscal year taxpayer, plants a citrus grove at the beginning of his taxable year ending in 1971. At the beginning of his taxable year ending in 1972, T sells the grove to X. The required period during which expenditures described in section 278 (a) are required to be capitalized runs from the date on which T planted the grove until the end of T's taxable year ending in 1974. Therefore, X must capitalize any such expenditures incurred by him from the time he purchased the grove from T until the end of T's taxable year ending in 1974.

(b) *Exceptions.* (1) Paragraph (a) of this section shall not apply to amounts allowable as deductions (without regard to section 278 or this section) and attributable to a citrus or almond grove (or part thereof) which is replanted by a taxpayer after having been lost or damaged (while in the hands of such taxpayer) by reason of freeze, disease, drought, pests, or casualty.

(2)(i) Paragraph (a) of this section shall not apply to amounts allowable as deductions (without regard to section 278 or this section), and attributable to a citrus grove (or part thereof) which was planted or replanted prior to December 30, 1969, or to an almond grove (or part thereof) which was planted or replanted prior to December 30, 1970.

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

Example 1. T, a fiscal year taxpayer with a taxable year of July 1, 1969, through v June 30, 1970, plants a citrus grove on August 1, 1969. Since the grove was planted prior to December 30, 1969, no expenses incurred with respect to the grove shall be subject to the provisions of paragraph (a).

Example 2. Assume the same facts as in *Example 1,* except that T plants the grove on March 1, 1970. Since the grove was planted after December 30, 1969, all amounts allowable as deductions (without regard to section 278 or this section) and attributable to the grove shall be subject to the provisions of paragraph (a). However, since paragraph (a) applies only to taxable years beginning after December 31, 1969, T must capitalize only those amounts incurred during his taxable years ending in 1971, 1972, and 1973.

[T.D. 7098, 36 FR 5214, Mar. 18, 1971, as amended by T.D. 7136, 36 FR 14731, Aug. 11, 1971]

§ 1.279–1 General rule; purpose.

An obligation issued to provide a consideration directly or indirectly for a corporate acquisition, although constituting a debt under section 385, may have characteristics which make it more appropriate that the participation in the corporation which the obligation represents be treated for purposes of the deduction of interest as if it were a stockholder interest rather than a creditors interest. To deal with such cases, section 279 imposes certain limitations on the deductibility of interest paid or incurred on obligations which have certain equity characteristics and are classified as corporate acquisition indebtedness. Generally, section 279 provides that no deduction will be allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent such interest exceeds $5 million. However, the $5 million limitation is reduced by the amount of interest paid or incurred on obligations issued under the circumstances described in section 279(a)(2) but which are not corporate acquisition indebtedness. Section 279(b) provides that an obligation will be corporate acquisition indebtedness if it was issued under certain circumstances and meets the four tests enumerated therein. Although an obligation may satisfy the conditions referred to in the preceding sentence, it may still escape classification as corporate acquisition indebtedness if the conditions as described in sections 279(d) (3), (4), and (5), 279(f), or 279(i) are present. However, no inference should be drawn from the rules of section 279 as to whether a particular instrument labeled a bond, debenture, note, or other evidence of indebtedness is in fact a debt. Before the determination as to whether the deduction for payments pursuant to an obligation as described in this section is to be disallowed, the obligation must first qualify as debt in accordance with section 385. If the obligation is not debt under section 385, it will be unnecessary to apply section 279 to any payments pursuant to such obligation.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]

§ 1.279–2 Amount of disallowance of interest on corporate acquisition indebtedness.

(a) *In general.* Under section 279(a), no deduction is allowed for any interest paid or incurred by a corporation during the taxable year with respect to its corporate acquisition indebtedness to the extent that such interest exceeds:

(1) $5 million, reduced by

(2) The amount of interest paid or incurred by such corporation during such year on any obligation issued after December 31, 1967, to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) but which is not corporate acquisition indebtedness. Such an obligation is not corporate acquisition indebtedness if it:

(i) Was issued prior to October 10, 1969, or

(ii) Was issued after October 9, 1969, but does not meet any one or more of the tests of section 279(b) (2), (3), or (4), or

(iii) Was originally deemed to be corporate acquisition indebtedness but is no longer so treated by virtue of the application of paragraphs (3) or (4) of section 279(d) or

(iv) Is specifically excluded from treatment as corporate acquisition indebtedness by virtue of sections 279(d)(5), (f), or (i).

The computation of the amount by which the $5 million limitation described in this paragraph is to be reduced with respect to any taxable year is to be made as of the last day of the taxable year in which an acquisition described in section 279(b)(1) occurs. In no case shall the $5 million limitation be reduced below zero.

(b) *Certain terms defined.* When used in section 279 and the regulations thereunder:

(1) The term *issued* includes the giving of a note or other evidence of indebtedness to a bank or other lender as well as an issuance of a bond or debenture. In the case of obligations which are registered with the Securities and Exchange Commission, the date of issue is the date on which the issue is first offered to the public. In the case of obligations which are not so registered, the date of issue is the date on which the obligation is sold to the first purchaser.

(2) The term *interest* includes both stated interest and unstated interest (such as original issue discount as defined in paragraph (a)(1) of § 1.163–4 and amounts treated as interest under section 483).

(3) The term *money* means cash and its equivalent.

(4) The term *control* shall have the meaning assigned to such term by section 368(c).

(5) The term *affiliated group* shall have the meaning assigned to such term by section 1504(a), except that all corporations other than the acquired corporation shall be treated as includible corporations (without any exclusion under section 1504(b)) and the acquired corporation shall not be treated as an includible corporation. This definition shall apply whether or not some or all of the members of the affiliated group file a consolidated return.

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

Example 1. On March 4, 1973, X Corporation, a calendar year taxpayer, issues an obligation which satisfies the test of section 279(b)(1) but fails to satisfy either of the tests of section 279(b) (2) or (3). Since at least one of the tests of section 279(b) is not satisfied the obligation is not corporate acquisition indebtedness. However, since the test of section 279(b)(1) is satisfied, the interest on the obligation will reduce the $5 million limitation provided by section 279 (a)(1).

Example 2. On January 1, 1969, X Corporation, a calendar year taxpayer, issues an obligation, which satisfies all the tests of section 279(b), requiring it to pay $3.5 million of interest each year. Since the obligation was issued before October 10, 1969, the obligation cannot be corporate acquisition indebtedness, and a deduction for the $3.5 million of interest attributable to such obligation is not subject to disallowance under section 279(a). However, since the obligation was issued after December 31, 1967, in an acquisition described in section 279(b)(1), under section 279(a)(2) the $3.5 million of interest attributable to such obligation reduces the $5 million limitation provided by section 279(a)(1) to $1.5 million.

Example 3. Assume the same facts as in *Example 2.* Assume further that on January 1, 1970, X Corporation issues more obligations which are classified as corporate acquisition indebtedness and which require X Corporation to pay $4 million of interest each year. For 1970 the amount of interest paid or accrued on corporate acquisition indebtedness, which may be deducted is $1.5 million ($5 million maximum provided by section 279(a)(1) less $3.5 million, the reduction required under section 279(a)(2)). Thus, $2.5 million of the $4 million interest incurred on a corporate acquisition indebtedness is subject to disallowance under section 279(a) for the taxable year 1970.

Example 4. Assume the same facts as in *Example 3.* Assume further that on the last day of each of the taxable years 1971, 1972, and 1973 of X Corporation neither of the conditions described in section 279(b)(4) was present.

Under these circumstances, such obligations for all taxable years after 1973 are not corporate acquisition indebtedness under section 279(d)(4). Therefore, the $2.5 million of interest previously not deductible is not deductible for all taxable years after 1973. Although such obligations are no longer treated as corporate acquisition indebtedness, the interest attributable thereto must be applied in further reduction of the $5 million limitation. The $5 million limitation of section 279(a)(1) is therefore reduced to zero. While the limitation is at the zero level any interest paid or incurred on corporate acquisition indebtedness will be disallowed.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]

§ 1.279–3 Corporate acquisition indebtedness.

(a) *Corporate acquisition indebtedness.* For purposes of section 279, the term *corporate acquisition indebtedness* means any obligation evidenced by a bond, debenture, note, or certificate or other evidence of indebtedness issued after October 9, 1969, by a corporation (referred to in section 279 and the regulations thereunder as ''issuing corporation'') if the obligation is issued to provide consideration directly or indirectly for the acquisition of stock in, or certain assets of, another corporation (as described in paragraph (b) of this § 1.279–3), is ''subordinated'' (as described in paragraph (c) of this § 1.279–3), is ''convertible'' (as described in paragraph (d) of this § 1.279–3), and satisfies either the ratio of debt to equity test (as described in paragraph (f) of § 1.279–5) or the projected earnings test (as described in paragraph (d) of § 1.279–5).

(b) *Acquisition of stock or assets.* (1) Section 279(b)(1) describes one of the tests to be satisfied if an obligation is to be classified as corporate acquisition indebtedness. Under section 279(b)(1), the obligation must be issued to provide consideration directly or indirectly for the acquisition of:

(i) Stock (whether voting or nonvoting) in another corporation (referred to in section 279 and the regulations thereunder as ''acquired corporation''), or

(ii) Assets of another corporation (referred to in section 279 and the regulations thereunder as ''acquired corporation'') pursuant to a plan under which at least two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by such corporation are acquired.

The fact that the corporation that issues the obligation is not the same corporation that acquires the acquired corporation does not prevent the application of section 279. For example, if X Corporation acquires all the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.

(2) *Direct or indirect consideration.* Obligations are issued to provide direct consideration for an acquisition within the meaning of section 279(b)(1) where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions of this subsection relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section 279(b)(1) where (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

(3) *Stock acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of stock in the acquired corporation shall be treated as a stock acquisition within the meaning of section 279(b)(1)(A). Where the stock of one corporation is acquired from another corporation and such stock constitutes at least two-thirds (in value) of all the assets (excluding money) of the latter corporation, such acquisition shall be deemed an asset acquisition as described in section 279(b)(1)(B) and subparagraph (4) of this section. If the issuing corporation acquires less than two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by the acquired corporation within the meaning of section 279(b)(1)(B) and subparagraph (4) of this paragraph and such assets include stock of another corporation, the acquisition of such stock is a stock acquisition within the meaning of section 279(b)(1)(A) and of this subparagraph. In such a case the amount of the obligation which is characterized as corporate acquisition indebtedness shall bear the same relationship to the total amount of the obligation issued as the fair market value of the stock acquired bears to the total of the fair market value of the assets acquired and stock acquired, as of the date of acquisition. For rules with respect to acquisitions of stock, where the total amount of stock of the acquired corporation held by the issuing corporation never exceeded 5 percent of the total combined voting power of all classes of stock of the acquired corporation entitled to vote, see §1.279–4(b)(1).

(ii) If the issuing corporation acquired stock of an acquired corporation in an acquisition described in section 279(b)(1)(A), and liquidated the acquired corporation under section 334(b)(2) and the regulations thereunder before the last day of the taxable year in which such stock acquisition is made, such obligation issued to provide consideration directly or indirectly to acquire such stock of the acquired corporation shall be considered as issued in an acquisition described in section 279(b)(1)(B).

(4) *Asset acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of assets of an acquired corporation pursuant to a plan under which at least

two-thirds of the gross value of all the assets (excluding money) used in trades and businesses carried on by such acquired corporation are acquired shall be treated as an asset acquisition within the meaning of section 279(b)(1)(B). For purposes of section 279(b)(1)(B), the gross value of any acquired asset shall be its fair market value as of the day of its acquisition. In determining the fair market value of an asset, no reduction shall be made for any liabilities, mortgages, liens, or other encumbrances to which the asset or any part thereof may be subjected. For purposes of this subparagraph, an asset which has been actually used in the trades and businesses of a corporation but which is temporarily not being used in such trades and businesses shall be treated as if it is being used in such manner. For purposes of this paragraph, the day of acquisition will be determined by reference to the facts and circumstances surrounding the transaction.

(ii) For purposes of the two-thirds test described in section 279(b)(1)(B), the stock of any corporation which is controlled by the acquired corporation shall be considered as an asset used in the trades and businesses of such acquired corporation.

(5) *Certain nontaxable transactions.* (i) Under section 279(e), an acquisition of stock of a corporation of which the issuing corporation is in control in a transaction in which gain or loss is not recognized shall be deemed an acquisition described in section 279(b)(1)(A) only if immediately before such transaction the acquired corporation was in existence, and the issuing corporation was not in control of such corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g), the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation, owned by members of the affiliated group, shall be aggregated in determining whether the issuing corporation was in control of the acquired corporation.

(ii) The $5 million limitation provided by section 279(a)(1) is not reduced by the interest on an obligation issued in a transaction which, under section 279 (e), is deemed not to be an acquisition described in section 279(b)(1).

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

Example 1. On January 1, 1973, W Corporation, a calendar year taxpayer, issues to the public 10,000 10 year convertible bonds each with a principal of $1,000 for $9 million. On June 6, 1973, W Corporation transfers the $9 million proceeds of such bond issue to X Corporation in exchange for X Corporation's common stock in a transaction that satisfies the provisions of section 351(a). On December 31, 1973, W Corporation's ratio of debt to equity is 1½ to 1 and its project earnings exceed three times the annual interest to be paid or incurred. Immediately prior to the transaction between the two corporations W Corporation owned no stock in X Corporation which had been in existence for several years. However, immediately after this transaction W Corporation is in control of X Corporation. Since X Corporation, the acquired corporation, was in existence and W Corporation, the issuing corporation, was not in control of X Corporation immediately before the section 351 transaction (a transaction in which gain or loss is not recognized) and since W Corporation is now in control of X Corporation, the acquisition of X Corporation's common stock by W Corporation is not protected from treatment as an acquisition described in section 279(b)(1)(A). However, the obligation will not be deemed to be corporate acquisition indebtedness since the test of section 279(b)(4) is not met. The interest on the obligation will reduce the $5 million limitation of section 279(a).

Example 2. Assume the facts are the same as described in *Example 1,* except that X Corporation was not in existence prior to June 6, 1973, but rather is newly created by W Corporation on such date. Since X Corporation, the acquired corporation, was not in existence before June 6, 1973, the date on which W Corporation, the issuing corporation, acquired control of X Corporation in a transaction on which gain or loss is not recognized, the acquisition is not deemed to be an acquisition described in section 279(b)(1)(A). Thus, under the provisions of subdivision (ii) of this subparagraph, the $5 million limitation provided by section 279(a)(1) will not be reduced by the yearly interest incurred on the convertible bonds issued by W Corporation.

Example 3. Assume that the facts are the same as described in *Example 1,* except that W Corporation was in control of X Corporation immediately before the transaction. Since W Corporation was in control of X Corporation immediately before the section

351(a) transaction and is in control of X Corporation after such transaction, the result will be the same as in *Example 2*.

(c) *Subordinated obligation*—(1) *In general*. An obligation which is issued to provide consideration for an acquisition described in section 279(b)(1) is subordinated within the meaning of section 279(b)(2) if it is either:

(i) Subordinated to the claims of trade creditors of the issuing corporation generally, or

(ii) Expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation, irrespective of whether such subordination relates to payment of interest, or principal, or both. In applying section 279 (b)(2) and this paragraph in any case where the issuing corporation is a member of an affiliated group of corporations, the affiliated group shall be treated as the issuing corporation.

(2) *Expressly subordinated obligation*. In applying subparagraph (1)(ii) of this paragraph, an obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself, or in another agreement between the parties to such obligation. An obligation shall be considered to be expressly subordinated within the meaning of subparagraph (1)(ii) of this paragraph if such obligation by its terms can become subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness which is outstanding or which may be issued subsequently. However, an obligation shall not be considered expressly subordinated if such subordination occurs solely by operation of law, such as in the case of bankruptcy laws. For purposes of this paragraph, the term *substantial amount of unsecured indebtedness* means an amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligations issued within the meaning of section 279(b)(1).

(d) *Convertible obligation*. An obligation which is issued to provide consideration directly or indirectly for an acquisition described in section 279 (b)(1) is convertible within the meaning of section 279(b)(3) if it is either—(1) Convertible directly or indirectly into stock of the issuing corporation, or (2) Part of an investment unit or other arrangement which includes, in addition to such bond or other evidence of indebtedness, an option to acquire directly or indirectly stock in the issuing corporation. Stock warrants or convertible preferred stock included as part of an investment unit constitute options within the meaning of the preceding sentence. Indebtedness is indirectly convertible if the conversion feature gives the holder the right to convert into another bond of the issuing corporation which is then convertible into the stock of the issuing corporation. In any case where the corporation which in fact issues an obligation to provide consideration for an acquisition described in section 279(b)(1) is a member of an affiliated group, the provisions of section 279(b)(3) and this paragraph are deemed satisfied if the stock into which either the obligation or option which is part of an investment unit or other arrangement is convertible, directly or indirectly, is stock of any member of the affiliated group.

(e) *Ratio of debt to equity and projected earnings test*. For rules with respect to the application of section 279(b)(4) (relating to the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred), see paragraphs (d), (e), and (f) of §1.279–5.

(f) *Certain obligations issued after October 9, 1969*—(1) *In general*. Under section 279(i), an obligation shall not be corporate acquisition indebtedness if such obligation is issued after October 9, 1969, to provide consideration for the acquisition of:

(i) Stock or assets pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition, or

(ii) Stock in any corporation where the issuing corporation, on October 9, 1969, and at all times thereafter before such acquisition, owned at least 50 percent of the total combined voting power of all classes of stock entitled to vote of the acquired corporation.

Subdivision (ii) of this subparagraph shall cease to apply when (at any time on or after October 9, 1969) the issuing corporation has acquired control of the acquired corporation. The interest attributable to any obligation which satisfies the conditions stated in the first sentence of this subparagraph shall reduce the $5 million limitation of section 279(a)(1).

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

Example 1. On September 5, 1969, M Corporation, a calendar year taxpayer, entered into a binding written contract with N Corporation to purchase 20 percent of the voting stock of N Corporation. The contract was in effect on October 9, 1969, and at all times thereafter before the acquisition of the stock on January 1, 1970. Pursuant to such contract M Corporation issued on January 1, 1970, to N Corporation an obligation which satisfies the tests of section 279(b) requiring it to pay $1 million of interest each year. However, under the provisions of subparagraph (1)(i) of this paragraph, such obligation is not corporate acquisition indebtedness since it was issued to provide consideration for the acquisition of stock pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition. The $1 million of yearly interest on the obligation reduces the $5 million limitation provided for in section 279(a)(1) to $4 million since such interest is attributable to an obligation which was issued to provide consideration for the acquisition of stock in an acquired corporation.

Example 2. On October 9, 1969, O Corporation, a calendar year taxpayer, owned 50 percent of the total combined voting power of all classes of stock entitled to vote of P Corporation. P Corporation has no other class of stock. On January 1, 1970, while still owning such voting stock O Corporation issued to the shareholders of P Corporation to provide consideration for an additional 40 percent of P Corporation's voting stock an obligation which satisfied the tests of section 279(b) requiring it to pay $4 million of interest each year. Hence, O Corporation acquired control of P Corporation, and the provisions of subparagraph (1)(ii) of this paragraph ceased to apply to O Corporation. Thus, 75 percent of the obligation issued by O Corporation to provide consideration for the stock of P Corporation is not corporate acquisition indebtedness (that is, of the 40 percent of the voting stock of P Corporation which was acquired, only 30 percent was needed to give O Corporation control). Since 25 percent of the obligation is corporate acquisition indebtedness, $1 million of interest attributable to such obligation is subject to disallowance under section 279(a) for the taxable year 1970. The remaining $3 million of interest attributable to the obligation will reduce the $5 million limitation provided by in section 279(a)(1).

(g) *Exemptions for certain acquisitions of foreign corporations*—(1) *In general.* Under section 279(f), the term *corporate acquisition indebtedness* does not include any indebtedness issued to any person to provide consideration directly or indirectly for the acquisition of stock in, or assets of, any foreign corporation substantially all the income of which, for the 3-year period ending with the date of such acquisition or for such part of such period as the foreign corporation was in existence, is from sources without the United States. The interest attributable to any obligation excluded from treatment as corporate acquisition indebtedness by reason of this paragraph shall reduce the $5 million limitation of 279(a)(1).

(2) *Foreign corporation.* For purposes of this paragraph, the term *foreign corporation* shall have the same meaning as in section 7701(a)(5).

(3) *Income from sources without the United States.* For purposes of this paragraph, the term *income from sources without the United States* shall be determined in accordance with sections 862 and 863. If more than 80 percent of a foreign corporation's gross income is derived from sources without the United States, such corporation shall be considered to be deriving substantially all of its income from sources without the United States.

[T.D. 7262, 38 FR 5845, Mar. 5, 1973]

§ 1.279–4 Special rules.

(a) *Special 3-year rule.* Under section 279(d)(4), if an obligation which has been deemed to be corporate acquisition indebtedness for any taxable year would not be such indebtedness for each of any 3 consecutive taxable years thereafter if the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred of section 279 (b)(4) were applied as of the close of each of such 3 years, then such obligation shall not be corporate acquisition indebtedness for any taxable years after such 3 consecutive taxable years. The test prescribed by section 279(b)(4) shall be applied as of the close of any taxable year whether or not the issuing corporation issues any obligation to provide consideration for an acquisition described in section 279(b)(1) in such taxable year. Thus, for example, if a corporation, reporting income on a calendar year basis, has an obligation outstanding as of December 31, 1975, which was classified as a corporate acquisition indebtedness as of the close of 1972 and such obligation would not have been classified as corporate acquisition indebtedness as of the close of 1973, 1974, and 1975 because neither of the conditions of section 279(b)(4) were present as of such dates, then such obligation shall not be corporate acquisition indebtedness for 1976 and all taxable years thereafter. Such obligation shall not be reclassified as corporate acquisition indebtedness in any taxable year following 1975, even if the issuing corporation issues more obligations (whether or not found to be corporate acquisition indebtedness) in such later years to provide consideration for the acquisition of additional stock in, or assets of, the same acquired corporation with respect to which the original obligation was issued. The interest attributable to such obligation shall reduce the $5 million limitation provided by section 279(a)(1) for 1976 and all taxable years thereafter.

(b) *Five percent stock rule*—(1) *In general*. Under section 279(d)(5), if an obligation issued to provide consideration for an acquisition of stock in another corporation meets the tests of section 279(b), such obligation shall be corporate acquisition indebtedness for a taxable year only if at sometime after October 9, 1969, and before the close of such year the issuing corporation owns or has owned 5 percent or more of the total combined voting power of all classes of stock entitled to vote in the acquired corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation owned by members of the affiliated group shall be aggregated to determine if the percentage limitation provided by this subparagraph is exceeded. Once an obligation is deemed to be corporate acquisition indebtedness such obligation will continue to be deemed corporate acquisition indebtedness for all taxable years thereafter unless the provisions of section 279(d) (3) or (4) apply, notwithstanding the fact that the issuing corporation owns less than 5 percent of the combined voting power of all classes of stock entitled to vote of the acquired corporation in any or all taxable years thereafter.

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

Example 1. Corporation Y uses the calendar year as its taxable year and has only one class of stock outstanding. On June 1, 1972, X Corporation which is also a calendar year taxpayer and which has never been a shareholder of Y Corporation acquires from the shareholders of Y Corporation 4 percent of the stock of Y Corporation in exchange for obligations which satisfy the conditions of section 279(b). At no time during 1972 does X Corporation own 5 percent or more of the stock of Y Corporation. Accordingly, under the provisions of subparagraph (1) of this paragraph, for 1972 the obligations issued by X Corporation to provide consideration for the acquisition of Y Corporation's stock do not constitute corporate acquisition indebtedness.

Example 2. Assume the same facts as in *Example 1*. Assume further that on February 24, 1973, X Corporation acquires from the shareholders of Y Corporation an additional 7 percent of the stock of Y Corporation in exchange for obligations which satisfy all of the tests of section 279(b). On December 28, 1973, X Corporation sells all of its stock in Y Corporation. For 1973, the obligations issued by X Corporation in 1972 and in 1973 constitute corporate acquisition indebtedness since X Corporation at some time after October 9, 1969, and before the close of 1973 owned 5 percent or more of the voting stock of Y Corporation. Furthermore, such obligations shall be corporate acquisition indebtedness for all taxable years thereafter unless the special provisions of section 279(d) (3) or (4) could apply.

(c) *Changes in obligation*—(1) *In general*. Under section 279(h), for purposes of section 279:

(i) Any extension, renewal, or refinancing of an obligation evidencing a preexisting indebtedness shall not be deemed to be the issuance of a new obligation, and

(ii) Any obligation which is corporate acquisition indebtedness of the issuing corporation is also corporate acquisition indebtedness of any corporation which in any transaction or by operation of law assumes liability for such obligation or becomes liable for such obligation as guarantor, endorser, or indemnitor.

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

Example 1. On January 1, 1971, X Corporation, which files its return on the basis of a calendar year, issues an obligation, which satisfies the tests of section 279(b), and is deemed to be corporate acquisition indebtedness. On January 1, 1973, an agreement is concluded between X Corporation and the holder of the obligation whereby the maturity date of such obligation is extended until December 31, 1979. Under the provisions of subparagraph (1)(i) of this paragraph such extended obligation is not deemed to be a new obligation, and still constitutes corporate acquisition indebtedness.

Example 2. On June 12, 1971, X Corporation, a calendar year taxpayer, issued convertible and subordinated obligations to acquire the stock of Z Corporation. The obligations were deemed corporate acquisition indebtedness on December 31, 1971. On March 4, 1973, X Corporation and Y Corporation consolidated to form XY Corporation in accordance with State law. Corporation XY is liable for the obligations issued by X Corporation by operation of law and the obligations continue to be corporate acquisition indebtedness. In 1975 XY Corporation exchanges its own nonconvertible obligations for the obligations X Corporation issued. The obligations of XY Corporation issued in exchange for those of X Corporation will be deemed to be corporate acquisition indebtedness.

[T.D. 7262, 38 FR 5847, Mar. 5, 1973; 38 FR 6893, Mar. 14, 1973]

§ 1.279–5 Rules for application of section 279(b).

(a) *Taxable years to which applicable*—(1) *First year of disallowance.* Under section 279(d)(1), the deduction of interest on any obligation shall not be disallowed under section 279(a) before the first taxable year of the issuing corporation as of the last day of which the application of either section 279(b)(4) (A) or (B) results in such obligation being classified as corporate acquisition indebtedness. See section 279(c)(1) and paragraph (b)(2) of this section for the time when an obligation is subjected to the test of section 279(b)(4).

(2) *General rule for succeeding years.* Under section 279(d)(2), except as provided in paragraphs (3), (4), and (5) of section 279(d), if an obligation is determined to be corporate acquisition indebtedness as of the last day of any taxable year of the issuing corporation, such obligation shall be corporate acquisition indebtedness for such taxable year and all subsequent taxable years.

(b) *Time of determination*—(1) *In general.* The determination of whether an obligation meets the conditions of section 279(b) (1), (2), and (3) shall be made as of the day on which the obligation is issued.

(2) *Ratio of debt to equity, projected earnings, and annual interest to be paid or incurred.* (i) Under section 279(c)(1), the determination of whether an obligation meets the conditions of section 279(b)(4) is first to be made as of the last day of the taxable year of the issuing corporation in which it issues the obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) of stock in, or assets of, the acquired corporation. An obligation which is not corporate acquisition indebtedness only because it does not satisfy the test of section 279(b)(4) in the taxable year of the issuing corporation in which the obligation is issued for stock in, or assets of, the acquired corporation may be subjected to the test of section 279(b)(4) again. A retesting will occur in any subsequent taxable year of the issuing corporation in which the issuing corporation issues any obligation to provide consideration directly or indirectly for an acquisition described in section 279(b)(1) with respect to the same acquired corporation, irrespective of whether such subsequent obligation is itself classified as corporate acquisition indebtedness. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g) the affiliated group shall be treated as the issuing corporation. Thus, if any member of the affiliated group issues an obligation to acquire additional stock in, or assets of, the acquired corporation, this paragraph shall apply.

(ii) For purposes of section 279(b)(4) and this paragraph, in any case where the issuing corporation is a member of an affiliated group (see section 279(g) and § 1.279–6 for rules regarding application of section 279 to certain affiliated groups) which does not file a consolidated return and all the members of which do not have the same taxable year, determinations with respect to the ratio of debt to equity of, and projected earnings of, and annual interest to be paid or incurred by, any member of the affiliated group shall be made as of the last day of the taxable year of the corporation which in fact issues the obligation to provide consideration for an acquisition described in section 279(b)(1).

(3) *Redetermination where control or substantially all the properties have been acquired.* Under section 279(d)(3), if an obligation is determined to be corporate acquisition indebtedness as of the close of a taxable year of the issuing corporation in which section 279(c)(3)(A)(i) (relating to the projected earnings of the issuing corporation only) applied, but would not be corporate acquisition indebtedness if the determination were made as of the close of the first taxable year of such corporation thereafter in which section 279(c)(3)(A)(ii) (relating to the projected earnings of both the issuing corporation and the acquired corporation) could apply, such obligation shall be considered not to be corporate acquisition indebtedness for such later taxable year and all taxable years thereafter. Where an obligation ceases to be corporate acquisition indebtedness as a result of the application of this paragraph, the interest on such obligation shall not be disallowed under section 279(a) as a deduction for the taxable year in which the obligation ceases to be corporate acquisition indebtedness and all taxable years thereafter. However, under section 279(a)(2) the interest paid or incurred on such obligation which is allowed as a deduction will reduce the $5 million limitation provided by section 279(a)(1).

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

Example 1. In 1971, X Corporation, which files its Federal income tax return on the basis of a calendar year, issues its obligations to provide consideration for the acquisition of 15 percent of the voting stock of both Y Corporation and Z Corporation. Y Corporation and Z Corporation each have only one class of stock. When issued, such obligations satisfied the tests prescribed in section 279(b) (1), (2), and (3) and would have constituted corporate acquisition indebtedness but for the test prescribed in section 279(b)(4). On December 31, 1971, the application of section 279(b)(4) results in X Corporation's obligations issued in 1971 not being treated as corporate acquisition indebtedness for that year.

Example 2. Assume the same facts as in *Example 1,* except that in 1972, X Corporation issues more obligations which come within the tests of section 279(b) (1), (2), and (3) to acquire an additional 10 percent of the voting stock of Y Corporation. No stock of Z Corporation is acquired after 1971. The application of section 279(b)(4)(B) (relating to the projected earnings of X Corporation) as of the end of 1972 results in the obligations issued in 1972 to provide consideration for the acquisition of the stock of Y Corporation being treated as corporate acquisition indebtedness. Since X Corporation during 1972 did issue obligations to acquire more stock of Y Corporation, under the provisions of section 279(c)(1) and subparagraph (2) of this paragraph the obligations issued by X Corporation in 1971 to acquire stock in Y Corporation are again tested to determine whether the test of section 279(b)(4) with respect to such obligations is satisfied for 1972. Thus, since such obligations issued by X Corporation to acquire Y Corporation's stock in 1971 previously came within the provisions of section 279(b) (1), (2), and (3) and the projected earnings test of section 279(b)(4)(B) is satisfied for 1972, all of such obligations are to be deemed to constitute corporate acquisition indebtedness for 1972 and subsequent taxable years. The obligations issued in 1971 to acquire stock in Z Corporation continue not to constitute corporate acquisition indebtedness.

Example 3. Assume the same facts as in *Examples 1* and *2.* In 1973, X Corporation issues more obligations which come within the tests of section 279(b) (1), (2), and (3) to acquire more stock (but not control) in Y Corporation. On December 31, 1973, it is determined with respect to X Corporation that neither of the conditions described in section 279(b)(4) are present. Thus, the obligations issued in 1973 do not constitute corporate acquisition indebtedness. However, the obligations issued in 1971 and 1972 by X Corporation to acquire stock in Y Corporation continue to be treated as corporate acquisition indebtedness.

Example 4. Assume the same facts as in *Example 3,* except that X Corporation acquires control of Y Corporation in 1973. Since X Corporation has acquired control of Y Corporation, the average annual earnings (as defined in section 279(c)(3)(B) and the annual interest to be paid or incurred (as provided by section 279(c)(4)) of both X Corporation and Y Corporation under section 279(c)(3)(A)(ii) are taken into account in computing for 1973 the ratio of projected earnings to annual interest to be paid or incurred described in section 279(b)(4)(B). Assume further that after applying section 279(b)(4)(B) the obligations issued in 1973 escape treatment as corporate acquisition indebtedness for 1973. Under section 279(d)(3), all of the obligations issued by X Corporation to acquire stock in Y Corporation in 1971 and 1972 are removed from classification as corporate acquisition indebtedness for 1973 and all subsequent taxable years.

Example 5. In 1975, M Corporation, which files its Federal income tax return on the basis of a calendar year, issues its obligations to acquire 30 percent of the voting stock of N Corporation. N Corporation has only one class of stock. Such obligations satisfy the tests prescribed in section 279(b) (1), (2), and (3). Additionally, as of the close of 1975, M Corporation's ratio of debt to equity exceeds the ratio of 2 to 1 and its projected earnings do not exceed three times the annual interest to be paid or incurred. The obligations issued by M Corporation are corporate acquisition indebtedness for 1975 since all the provisions of section 279(b) are satisfied. In 1976 M Corporation issues its obligations to acquire from the shareholders of N Corporation an additional 60 percent of the voting stock of N Corporation, thereby acquiring control of N Corporation. However, with respect to the obligations issued by M Corporation in 1975, there is no redetermination under section 279(d)(3) and subparagraph (3) of this paragraph as to whether such obligations may escape classification as corporate acquisition indebtedness because in 1975 it was the ratio of debt to equity test which caused such obligations to be corporate acquisition indebtedness. If in 1975, M Corporation met the conditions of section 279(b)(4) solely because of the ratio of projected earnings to annual interest to be paid or incurred described in section 279(b)(4)(B), its obligation issued in 1975 could be retested in 1976.

(c) *Acquisition of stock or assets of several corporations.* An issuing corporation which acquires stock in, or assets of, more than one corporation during any taxable year must apply the tests described in section 279(b) (1), (2), and (3) separately with respect to each obligation issued to provide consideration for the acquisition of the stock in, or assets of, each such acquired corporation. Thus, if an acquisition is made with obligations of the issuing corporation that satisfy the tests described in section 279(b) (2) and (3) and obligations that fail to satisfy such tests, only those obligations satisfying such tests need be further considered to determine whether they constitute corporate acquisition indebtedness. Those obligations which meet the test of section 279(b)(1) but which are not deemed corporate acquisition indebtedness shall be taken into account for purposes of determining the reduction in the $5 million limitation of section 279(a)(1).

(d) *Ratio of debt to equity and projected earnings*—(1) *In general.* One of the four tests to determine whether an obligation constitutes corporate acquisition indebtedness is contained in section 279(b)(4). An obligation will meet the test of section 279(b)(4) if, as of a day determined under section 279(c)(1) and paragraph (b)(2) of this section, either:

(i) The ratio of debt to equity (as defined in paragraph (f) of this section) of the issuing corporation exceeds 2 to 1, or

(ii) The projected earnings (as defined in subparagraph (2) of this paragraph) of the issuing corporation, or of both the issuing corporation and acquired corporation in any case where subparagraph (2)(ii) of this paragraph is applicable, do not exceed three times the annual interest to be paid or incurred (as defined in paragraph (e) of this section) by such issuing corporation, or, where applicable, by such issuing corporation and acquired corporation. Where paragraphs (d)(2)(ii) and (e)(1)(ii) of this section are applicable in computing projected earnings and annual interest to be paid or incurred, 100 percent of the acquired corporation's projected earnings and annual interest to be paid or incurred shall be included in such computation, even though less than all of the stock or assets of the acquired corporation have been acquired.

(2) *Projected earnings.* The term *projected earnings* means the ''average annual earnings'' (as defined in subparagraph (3) of this paragraph) of:

(i) The issuing corporation only, if subdivision (ii) of this subparagraph, does not apply, or

(ii) Both the issuing corporation and the acquired corporation, in any case where the issuing corporation as of the close of its taxable year has acquired control, or has acquired substantially all of the properties, of the acquired corporation.

For purposes of subdivision (ii) of this subparagraph, an acquisition of ''substantially all of the properties'' of the acquired corporation means the acquisition of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the acquired corporation immediately prior to the acquisition.

(3) *Average annual earnings.* (i) The term *average annual earnings* referred to in subparagraph (2) of this paragraph is, for any corporation, the amount of its earnings and profits for any 3-year period ending with the last day of a taxable year of the issuing corporation in which it issues any obligation to provide consideration for an acquisition described in section 279(b)(1), computed without reduction for:

(*a*) Interest paid or incurred,

(*b*) Depreciation or amortization allowed under Chapter 1 of the Code,

(*c*) Liability for tax under Chapter 1 of the Code, and

(*d*) Distributions to which section 301(c)(1) apply (other than such distributions from the acquired corporation to the issuing corporation), and reduced to an annual average for such 3-year period. For the rules to determine the amount of earnings and profits of any corporation, see section 312 and the regulations thereunder.

(ii) Except as provided for in subdivision (iii) of this subparagraph, for purposes of subdivision (i) of this subparagraph in the case of any corporation, the earnings and profits for such 3-year period shall be reduced to an annual average by dividing such earnings and profits by 36 and multiplying the quotient by 12. If a corporation was not in existence during the entire 36-month period as of the close of the taxable year referred to in subdivision (i) of this subparagraph, its average annual earnings shall be determined by dividing its earnings and profits for the period of its existence by the number of whole calendar months in such period and multiplying the quotient by 12.

(iii) Where the issuing corporation acquires substantially all of the properties of an acquired corporation, the computation of earnings and profits of such acquired corporation shall be made for the period of such corporation beginning with the first day of the 3-year period of the issuing corporation and ending with the last day prior to the date on which substantially all of the properties were acquired. In determining the number of whole calendar months for such acquired corporation where the period for determining its earnings and profits includes 2 months which are not whole calendar months and the total number of days in such 2 fractional months exceeds 30 days, the number of whole calendar months for such period shall be increased by one. Where the number of days in the 2 fractional months total 30 days or less such fractional months shall be disregarded. After the number of whole calendar months is determined, the calculation for average annual earnings shall be made in the same manner as described in the last sentence of subdivision (ii) of this subparagraph.

(e) *Annual interest to be paid or incurred*—(1) *In general.* For purposes of section 279(b)(4)(B), the term *annual interest to be paid or incurred* means:

(i) If subdivision (ii) of this subparagraph does not apply, the annual interest to be paid or incurred by the issuing corporation only, for the taxable year beginning immediately after the day described in section 279(c)(1), determined by reference to its total indebtedness outstanding as of such day, or

(ii) If projected earnings are determined under paragraph (d)(2)(ii) of this section, the annual interest to be paid or incurred by both the issuing corporation and the acquired corporation for 1 year beginning immediately after the day described in section 279(c)(1), determined by reference to their combined total indebtedness outstanding as of such day. However, where the issuing corporation acquires substantially all of the properties of the acquired corporation, the annual interest to be paid or incurred will be determined by reference to the total indebtedness outstanding of the issuing corporation only (including any indebtedness it assumed in the acquisition) as of the day described in section 279(c)(1).

The term *annual interest to be paid or incurred* refers to both actual interest and unstated interest. Such unstated interest includes original issue discount as defined in paragraph (a)(1) of §1.163–4 and amounts treated as interest under section 483. For purposes of this paragraph and paragraph (f) of this section (relating to the ratio of debt to equity), the indebtedness of any corporation shall be determined in accordance with generally accepted accounting principles. Thus, for example, the indebtedness of a corporation includes short-term liabilities, such as accounts payable to suppliers, as well as long-term indebtedness. Contingent liabilities, such as those arising out of discounted notes, the assignment of accounts receivable, or the guarantee of the liability of another, shall be included in the determination of the indebtedness of a corporation if the contingency is likely to become a reality. In addition, the indebtedness of a corporation includes obligations issued by the corporation, secured only by property of the corporation, and with respect to which the corporation is not personally liable. See section 279(g) and §1.279–6 for rules with respect to the computation of annual interest to be paid or incurred in regard to members of an affiliated group of corporations.

(2) *Examples.* The provisions of these paragraphs may be illustrated by the following examples:

Example 1. Corporation X's earnings and profits calculated in accordance with section 279(c)(3)(B) for 1972, 1971, and 1970 respectively were $29 million, $23 million, and $20 million. The interest to be paid or incurred during the calendar year of 1973 as determined by reference to the issuing corporation's total outstanding indebtedness as of December 31, 1972, was $10 million. By dividing the sum of the earnings and profits for the 3 years by 36 (the number of whole calendar months in the 3-year period) and multiplying the quotient by 12, the average annual earnings for X Corporation is $24 million. Since the projected earnings of X Corporation do not exceed by three times the annual interest to be paid or incurred (they exceed by only 2.4 times), one of the circumstances described in section 279(b)(4) is present.

Example 2. On March 1, 1972, W Corporation acquires substantially all of the properties of Z Corporation in exchange for W Corporation's bonds which satisfy the tests of section 279(b) (2) and (3). W Corporation files its income tax returns on the basis of fiscal years ending June 30. Z Corporation, which was formed on September 1, 1969, is a calendar year taxpayer. The earnings and profits of W Corporation for the last 3 fiscal years ending June 30, 1972, calculated in accordance with the provisions of section 279(c)(3)(B) were $300 million, $400 million, and $380 million, respectively. The average annual earnings of W Corporation is $360 million ($1,080 million ÷ 36 × 12). The earnings and profits of Z Corporation calculated in accordance with the provisions of section 279(c)(3)(B) were $4 million for the period of September 1, 1969 to December 31, 1969, $10 million and $14 million for the calendar years of 1970 and 1971, respectively, and $2 million for the period of January 1, 1972, through February 29, 1972, or a total of $30 million. To arrive at the average annual earnings, the sum of the earnings and profits, $30 million, must be divided by 30 (the number of whole calendar months that Z Corporation was in existence during W Corporation's 3-year period ending with the day prior to the date substantially all the assets were acquired) and the quotient is multiplied by 12, which results in an average annual earnings of $12 million ($30 million ÷ 30 × 12) for Z Corporation. The combined average annual earnings of W Corporation and Z Corporation is $372 million. The interest for the fiscal year ending June 30, 1973, to be paid or incurred by W Corporation on its outstanding indebtedness as of June 30, 1972, is $110 million. Since the projected earnings exceed the annual interest to be paid or incurred by more than three times, the obligation will not be corporate acquisition indebtedness, unless the issuing corporation's debt to equity ratio exceeds 2 to 1.

(f) *Ratio of debt to equity*—(1) *In general.* The condition described in section 279(b)(4)(A) is present if the ratio of debt to equity of the issuing corporation exceeds 2 to 1. Under section 279(c)(2), the term *ratio of debt to equity* means the ratio which the total indebtedness of the issuing corporation bears to the sum of its money and all its other assets (in an amount equal to adjusted basis for determining gain) less such total indebtedness. For the meaning of the term *indebtedness*, see paragraph (e)(1) of this section. See section 279(g) and §1.279–6 for rules with respect to the computation of the ratio of debt to equity in regard to an affiliated group of corporations.

(2) *Examples.* The provisions of section 279(b)(4)(A) and this paragraph may be illustrated by the following example:

[$5 million interest to be paid or incurred × $80 million owed to X Bank by its customers/$100 million total indebtedness]

Example 1. On June 1, 1971, X Corporation, which files its federal income tax returns on a calendar year basis, issues an obligation for $45 million to the shareholders of Y Corporation to provide consideration for the acquisition of all of the stock of Y Corporation. Such obligation has the characteristics of corporate acquisition indebtedness described in section 279(b) (2) and (3). The projected earnings of X Corporation and Y Corporation exceed 3 times the annual interest to be paid or incurred by those corporations and, accordingly, the condition described in section 279(b)(4)(B) is not present. Also, on December 31, 1971, X Corporation has total assets with an adjusted basis of $150 million (including the newly acquired stock of Y Corporation having a basis of $45 million) and total indebtedness of $90 million. Hence, X Corporation's equity is $60 million computed by subtracting its $90 million of total indebtedness from its $150 million of total assets. Since X Corporation's ratio of debt to equity of 1.5 to 1 ($90 million of total indebtedness over $60 million equity) does not exceed 2 to 1, the condition described in section 279(b)(4)(A) is not present. Therefore, X Corporation's obligation for $45 million is not corporate acquisition indebtedness because on December 31, 1971, neither of the conditions specified in section 279(b)(4) existed.

(g) *Special rules for banks and lending or finance companies*—(1) *Debt to equity and projected earnings.* Under section 279(c)(5), with respect to any corporation which is a bank (as defined in section 581) or is primarily engaged in a lending or finance business, the following rules are to be applied:

(i) In determining under paragraph (f) of this section the ratio of debt to equity of such corporation (or of the affiliated group of which such corporation is a member), the total indebtedness of such corporation (and the assets of such corporation) shall be reduced by an amount equal to the total indebtedness owed to such corporation which arises out of the banking business of such corporation, or out of the lending or finance business of such corporation, as the case may be;

(ii) In determining under paragraph (e) of this section the annual interest to be paid or incurred by such corporation (or by the issuing corporation and acquired corporation referred to in section 279(c)(4)(B) or by the affiliated group of corporations of which such corporation is a member), the amount of such interest (determined without regard to this subparagraph) shall be reduced by an amount which bears the same ratio to the amount of such interest as the amount of the reduction for the taxable year under subdivision (i) of this subparagraph bears to the total indebtedness of such corporation; and

(iii) In determining under section 279(c)(3)(B) the average annual earnings, the amount of the earnings and profits for the 3-year period shall be reduced by the sum of the reductions under subdivision (ii) of this subparagraph for such period.

For purposes of this paragraph, the term *lending or finance business* means a business of making loans or purchasing or discounting accounts receivable, notes, or installment obligations. Additionally, the rules stated in this paragraph regarding the application of the ratio of debt to equity, the determination of the annual interest to be paid or incurred, and the determination of the average annual earnings also apply if the bank or lending or finance company is a member of an affiliated group of corporations. However, the rules are to be applied only for purposes of determining the debt, equity, projected earnings and annual interest of the bank or lending or finance company which then are taken into account in determining the debt to equity ratio and ratio of projected earnings to annual interest to be paid or incurred by the affiliated group as a whole. Thus, these rules are to be applied to reduce the bank's or lending or finance corporation's indebtedness, annual interest to be paid or incurred, and average annual earnings which are taken into account with respect to the group, but are not to reduce the indebtedness of, annual interest to be paid or incurred by, and average annual earnings of, any corporation in the affiliated group which is not a bank or a lending or finance company. In determining whether any corporation which is a member of an affiliated group is primarily engaged in a lending or finance business, only the activities of such corporation, and not those of the whole group, are to be taken into account. See §1.279–6 for the application of section 279 to certain affiliated groups of corporations.

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

Example 1. As of the close of the taxable year, X Bank has a total indebtedness of $100 million, total assets of $115 million, and $80 million is owed to X Bank by its customers. Bank X's indebtedness is $20 million ($100 million total indebtedness less $80 million owed to the X Bank by its customers) and its assets are $35 million ($115 million total assets less $80 million owed to the bank by its customers). If its annual interest to be paid or incurred is $5 million, such amount is reduced by $4 million. Thus, X Bank's annual interest to be paid or incurred is $1 million.

Example 2. Assume the same facts as in *Example 1.* X Bank has earnings and profits of $23 million for the 3-year period used to determine projected earnings. In computing the average annual earnings, the $23 million amount will be reduced by $12 million (three times the $4 million reduction of interest in *Example 1*, assuming that the reduction was the same for each year). Thus X Bank's earnings and profits for such 3-year period are $11 million ($23 million total earnings and profits less $12 million reduction).

[T.D. 7262, 38 FR 5847, Mar. 7, 1973, as amended by T.D. 9264, 71 FR 30593, May 30, 2006]

§ 1.279–6 Application of section 279 to certain affiliated groups.

(a) *In general.* Under section 279(g), in any case in which the issuing corporation is a member of an affiliated group, the application of section 279 shall be determined by treating all of the members of the affiliated group in the aggregate as the issuing corporation, except that the ratio of debt to equity of, projected earnings of, and the annual interest to be paid or incurred by any corporation (other than the issuing corporation determined without regard to this paragraph) shall be included in the determinations required under section 279(b)(4) as of any day only if such corporation is a member of the affiliated group on such day, and, in determining projected earnings of such corporation under section 279(c)(3), there shall be taken into account only the earnings and profits of such corporation for the period during which it was a member of the affiliated group. The total amount of an affiliated member's assets, indebtedness, projected earnings, and interest to be paid or incurred will enter into the computation required by this section, irrespective of any minority ownership in such member.

(b) *Aggregate money and other assets.* In determining the aggregate money and all the other assets of the affiliated group, the money and all the other assets of each member of such group shall be separately computed and such separately computed amounts shall be added together, except that adjustments shall be made, as follows:

(1) There shall be eliminated from the aggregate money and all the other assets of the affiliated group intercompany receivables as of the date described in section 279(c)(1);

(2) There shall be eliminated from the total assets of the affiliated group any amount which represents stock ownership in any member of such group;

(3) In any case where gain or loss is not recognized on transactions between members of an affiliated group under paragraph (d)(3) of this section, the basis of any asset involved in such transaction shall be the transferor's basis;

(4) The basis of property in a transaction to which §1.1502–13 applies is the basis of the property determined under that section; and

(5) There shall be eliminated from the money and all the other assets of the affiliated group any other amount which, if included, would result in a duplication of amounts in the aggregate money and all the other assets of the affiliated group.

(c) *Aggregate indebtedness.* For purposes of applying section 279(c), in determining the aggregate indebtedness of an affiliated group of corporations the total indebtedness of each member of such group shall be separately determined, and such separately determined amounts shall be added together, except that there shall be eliminated from such total indebtedness as of the date described in section 279(c)(1):

(1) The amount of intercompany accounts payable,

(2) The amount of intercompany bonds or other evidences of indebtedness, and

(3) The amount of any other indebtedness which, if included, would result

in a duplication of amounts in the aggregate indebtedness of such affiliated group.

(d) *Aggregate projected earnings.* In the case of an affiliated group of corporations (whether or not such group files a consolidated return under section 1501), the aggregate projected earnings of such group is computed by separately determining the projected earnings of each member of such group under paragraph (d) of §1.279–5, and then adding together such separately determined amounts, except that—

(1) A dividend (a distribution which is described in section 301(c)(1) other than a distribution described in section 243(c)(1)) distributed by one member to another member is eliminated;

(2) In determining the earnings and profits of any member of an affiliated group, there is eliminated any amount of interest income received or accrued, and of interest expense paid or incurred, which is attributable to intercompany indebtedness; and

(3) No gain or loss is recognized in any transaction between members of the affiliated group.

(e) *Aggregate interest to be paid or incurred.* For purposes of section 279(c)(4), in determining the aggregate annual interest to be paid or incurred by an affiliated group of corporations, the annual interest to be paid or incurred by each member of such affiliated group shall be separately calculated under paragraph (e) of §1.279–5, and such separately calculated amounts shall be added together, except that any amount of annual interest to be paid or incurred on any intercompany indebtedness shall be eliminated from such aggregate interest.

[T.D. 7262, 38 FR 5850, Mar. 5, 1973, as amended by T.D. 8560, 59 FR 41675, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995; T.D. 10018, 89 FR 106851, Dec. 30, 2024]

§ 1.279–7 Effect on other provisions.

Under section 279(j), no inference is to be drawn from any provision in section 279 and the regulations thereunder that any instrument designated as a bond, debenture, note, or certificate or other evidence of indebtedness by its issuer represents an obligation or indebtedness of such issuer in applying any other provision of this title. Thus, for example, an instrument, the interest on which is not subject to disallowance under section 279 could, under section 385 and the regulations thereunder, be found to constitute a stock interest, so that any amounts paid or payable thereon would not be deductible.

[T.D. 7262, 38 FR 5851, Mar. 5, 1973]

§ 1.280B–1 Demolition of structures.

(a) *In general.* Section 280B provides that, in the case of the demolition of any structure, no deduction otherwise allowable under chapter 1 of subtitle A shall be allowed to the owner or lessee of such structure for any amount expended for the demolition or any loss sustained on account of the demolition, and that the expenditure or loss shall be treated as properly chargeable to the capital account with respect to the land on which the demolished structure was located.

(b) *Definition of structure.* For purposes of section 280B, the term *structure* means a building, as defined in §1.48–1(e)(1), including the structural components of that building, as defined in §1.48–1(e)(2).

(c) *Effective date.* This section is effective for demolitions commencing on or after December 30, 1997.

[T.D. 8745, 62 FR 67726, Dec. 30, 1997]

§ 1.280C–1 Disallowance of certain deductions for wage or salary expenses.

If an employer elects to claim the targeted jobs credit under section 44B (as amended by the Revenue Act of 1978), or elects to claim the new jobs credit under section 44B (as in effect prior to enactment of the Revenue Act of 1978), the employer must reduce its deduction for wage or salary expenses paid or incurred in the year the credit is earned by the amount allowable as credit (determined without regard to the provisions of section 53). In the case in which wages and salaries are capitalized the amount subject to depreciation must be reduced by an amount equal to the amount of the credit (determined without regard to the provisions of section 53) in determining the depreciation deduction. In the case of an employer who uses the full absorption method of inventory costing under §1.471–11, the portion of the basis of the inventory attributable to the wage or salary expenses giving rise to the credit and paid or incurred in the year the credit is earned must be reduced by the amount of the credit allowable (determined without regard to the provisions of section 53). If the employer is an organization that is under common control (as described in §1.52–1), it must reduce its deduction for wage or salary expenses by the amount of the credit apportioned to it under §1.52–1 (a) or (b). The deduction for wage and salary expenses must be reduced in the year the credit is earned, even if the employer is unable to use the credit in that year because of the limitations imposed by section 53.

(Secs. 44B, 381, and 7805 of the Internal Revenue Code of 1954, 92 Stat. 2834 (28 U.S.C. 44B); 91 Stat. 148 (26 U.S.C. 381(c)(26)); 68A Stat. 917 (28 U.S.C. 7805))

[T.D. 7921, 48 FR 52908, Nov. 23, 1983]

§ 1.280C–3 Disallowance of certain deductions for qualified clinical testing expenses when section 28 credit is allowable.

(a) *In general.* If a taxpayer is entitled to a credit under section 28 for qualified clinical testing expenses (as defined in section 28(b)), it must reduce the amount of any deduction for qualified clinical testing expenses paid or incurred in the year the credit is earned by the amount allowable as credit for such expenses (determined without regard to section 28(d)(2)).

(b) *Capitalization of qualified clinical testing expenses.* In a case in which qualified clinical testing expenses are capitalized, the amount chargeable to the capital account for a taxable year must be reduced by the excess of the amount of the credit allowable for the taxable year under section 28 (determined without regard to section 28(d)(2)) over the amount allowable as a deduction for qualified clinical testing expenses (determined without regard to paragraph (a) of this section) for the taxable year. See section 174 and the regulations thereunder.

(c) *Controlled group of corporations; organizations under common control.* In the case of a taxpayer described in paragraph (d)(5) of §1.28–1 of this chapter (relating to controlled groups of corporations and organizations under common control), paragraphs (a) and (b) of this section shall be applied in accordance with the rules prescribed for aggregation of expenditures under that paragraph.

(d) *Example.* The following example illustrates the application of paragraphs (a) and (b) of this section:

Example. A incurs $1,000 in clinical testing expenses for which a $500 credit is allowable under section 28. A also elects under section 174 of the Code to amortize these expenses over a 5-year period beginning in the year the credit is claimed. Under paragraph (a), the current year amortization deduction of $200 ($1,000 ÷ 5) is disallowed. Moreover, the amount which would otherwise be capitalized, $800, is reduced by the excess of the amount of the section 28 credit claimed for the taxable year over the amount of the allowable section 174 amortization deduction for the taxable year, or $300 ($500–$200). Thus, the amount chargeable to the capital account for the taxable year is $500 ($800–$300). A is entitled to amortize $500 over the remaining amortization period resulting in a deduction of $125 for each of the remaining four years.

[T.D. 8232, 53 FR 38715, Oct. 3, 1988]

§ 1.280C–4 Credit for increasing research activities.

(a) *In general.* An election under section 280C(c)(3) to have the provisions of section 280C(c)(1) and (c)(2) not apply and elect the reduced research credit under section 280C(c)(3)(B) shall be made on Form 6765, ''Credit for Increasing Research Activities'' (or any successor form). In order for the election to be effective, the Form 6765 must clearly indicate the taxpayer's intent to make the section 280C(c)(3) election, and must be filed with an original return for the taxable year filed on or before the due date (including extensions) for filing the income tax return for such year, regardless of whether any research credits are claimed on the original return. An election, once made for any taxable year, is irrevocable for that taxable year.

(b) *Controlled groups of corporations; trades or businesses under common control*—(1) *In general.* A member of a controlled group of corporations (within the meaning of section 41(f)(5)), or a trade or business which is treated as being under common control with other trades or businesses (within the meaning of section 41(f)(1)(B)), may make the election under section 280C(c)(3). However, only the common parent (within the meaning of §1.1502–77(a)(1)(i)) of a consolidated group may make the election on behalf of the members of a consolidated group. A member or trade or business shall make the election on Form 6765 and by the time prescribed in paragraph (a) of this section.

(2) *Example.* The following example illustrates an application of paragraph (b) of this section: A, B, and C, all of which are calendar year taxpayers, are members of a controlled group of corporations (within the meaning of section 41(f)(5)). A, B, and C each attach a statement to the 2012 Form 6765, ''Credit for Increasing Research Activities,'' showing A and C were the only members of the controlled group to have qualified research expenses when calculating the group credit. A and C report their allocated portions of the group credit on the 2012 Form 6765 and B reports no research credit on Form 6765. Pursuant to paragraph (a) of this section, A and B, but not C, each make an election for the reduced credit under section 280C(c)(3)(B) on the 2012 Form 6765. In December 2013, B determines it had qualified research expenses in 2012 resulting in an increased group credit. On an amended 2012 Form 6765, A, B, and C each report their allocated portions of the group credit. B reports its credit as a regular credit under section 41(a) and reduces the credit under section 280C(c)(3)(B). C may not reduce its credit under section 280C(c)(3)(B) because C did not make an election for the reduced credit with its original return.

(c)(1) *Effective/applicability date.* This section applies to taxable years ending on or after July 27, 2011.

(2) *Taxable years beginning after December 31, 2011.* Paragraphs (b)(2) and (c)(2) and (3) of this section apply to taxable years beginning on or after April 2, 2018. For taxable years ending before April 2, 2018, see §1.280C–4T as contained in 26 CFR part 1, as revised April 1, 2017.

(3) *For taxable years ending before January 1, 2012.* See §1.280C–4 as contained in 26 CFR part 1, revised April 1, 2014.

[T.D. 9539, 76 FR 44801, July 27, 2011, as amended by T.D. 9717, 80 FR 18099, Apr. 3, 2015; T.D. 9832, 83 FR 13185, Mar. 28, 2018]

§ 1.280F–1T Limitations on investment tax credit and recovery deductions under section 168 for passenger automobiles and certain other listed property; overview of regulations (temporary).

(a) *In general.* Section 280F(a) limits the amount of investment tax credit determined under section 46(a) and recovery deductions under section 168 for passenger automobiles. Section 280F(b) denies the investment tax credit and requires use of the straight line method of recovery for listed property that is not predominantly used in a qualified business use. In certain circumstances, section 280F(b) requires the recapture of an amount of cost recovery deductions previously claimed by the taxpayer. Section 280F(c) provides that lessees are to be subject to restrictions substantially equivalent to those imposed on owners of such property under section 280F (a) and (b). Section 280F(d) provides definitions and special rules; note that section 280F(d) (2) and (3) apply with respect to all listed property, even if the other provisions of section 280F do not affect the treatment of the property.

(b) *Key to Code provisions.* The following table identifies the provisions of section 280F under which regulations are provided, and lists each provision below with its corresponding regulation section:

Section 1.280F–2T	Section 1.280F–3T	Section 1.280F–4T	Sections 1.280F–5T and 1.280F–7	Section 1.280F–6
(a) (d)(1) (d)(8) (d)(10)	(b) (d)(1)	(d)(2)	(c)	(d)(3) (d)(4) (d)(5) (d)(6)

Sections 1.280F–2T(f) and 1.280F–4T(b) also provide special rules for improvements to passenger automobiles and other listed property that qualify as capital expenditures.

(c) *Effective dates*—(1) *In general.* This section and §§1.280F–2T through 1.280F–6 apply to property placed in service or leased after June 18, 1984, in taxable years ending after that date. Section 1.280F–7 applies to property leased after December 31, 1986, in taxable years ending after that date.

(2) *Exception.* This section and §§1.280F–2T through 1.280F–6 shall not apply to any property:

(i) Acquired pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, or under construction by the taxpayer on that date, but only if the property is placed in service before January 1, 1985 (January 1, 1987, in the case of 15-year real property), or

(ii) Leased pursuant to a binding contract in effect on June 18, 1984, and at all times thereafter, but only if the lessee first uses such property under the lease before January 1, 1985 (January 1, 1987, in the case of 15-year real property).

(3) *Leased passenger automobiles.* Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, and before January 1, 1987, in taxable years ending after April 2, 1985. Section 1.280F–5T(e) generally applies to passenger automobiles leased after April 2, 1985, in taxable years ending after that date. Section 1.280F–5T(e) does not apply to any passenger automobile that is leased pursuant to a binding contract, which is entered into no later than April 2, 1985, and which is in effect at all times thereafter, but only if the automobile is used under the lease before August 1, 1985. If §1.280F–5T(e) does not apply to a passenger automobile, *see* paragraph (c) (1) and (2) of this section. Section 1.280F–7(a) applies to passenger automobiles leased after December 31, 1986, in taxable years ending after that date.

[T.D. 7986, 49 FR 42704, Oct. 24, 1984, as amended by T.D. 8061, 50 FR 46038, Nov. 6, 1985; T.D. 8218, 53 FR 29881, Aug. 9, 1988; T.D. 8473, 58 FR 19060, Apr. 12, 1993; T.D. 9133, 69 FR 35514, June 25, 2004]

§1.280F–2T Limitations on recovery deductions and the investment tax credit for certain passenger automobiles (temporary).

(a) *Limitation on amount of investment tax credit*—(1) *General rule.* The amount of the investment tax credit determined under section 46(a) for any passenger automobile shall not exceed $1,000. For a passenger automobile placed in service after December 31, 1984, the $1,000 amount shall be increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(2) *Election of reduced investment tax credit.* If the taxpayer elects under section 48(q)(4) to reduce the amount of the investment tax credit in lieu of adjusting the basis of the passenger automobile under section 48(q)(1), the amount of the investment tax credit for any passenger automobile shall not exceed two-thirds of the amount determined under paragraph (a)(1) of this section.

(b) *Limitations on allowable recovery deductions*—(1) *Recovery deduction for year passenger automobile is placed in service.* For the taxable year that a taxpayer places a passenger automobile in service, the allowable recovery deduction under section 168(a) shall not exceed $4,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(2) *Recovery deduction for remaining taxable years during the recovery period.* For any taxable year during the recovery period remaining after the year that the property is placed in service, the allowable recovery deduction under section 168(a) shall not exceed $6,000. See paragraph (b)(3) of this section for the adjustment to this limitation.

(3) *Adjustment to limitation by reason of automobile price inflation adjustment.* The limitations on the allowable recovery deductions prescribed in paragraph (b) (1) and (2) of this section are increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which the automobile is placed in service.

(4) *Coordination with section 179.* For purposes of section 280F(a) and this section, any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction were a recovery deduction under section 168. Thus, the amount of the section 179 deduction is subject to

the limitations described in paragraph (b) (1) and (2) of this section.

(c) *Disallowed recovery deductions allowed for years subsequent to the recovery period*—(1) *In general*. (i) Except as otherwise provided in this paragraph (c), the ''unrecovered basis'' (as defined in paragraph (c)(1)(ii) of this section) of any passenger automobile is treated as a deductible expense in the first taxable year succeeding the end of the recovery period.

(ii) The term *unrecovered basis* means the excess (if any) of:

(A) The unadjusted basis (as defined in section 168(d)(1)(A), except that there is no reduction by reason of an election to expense a portion of the basis under section 179) of the passenger automobile, over

(B) The amount of the recovery deductions (including any section 179 deduction elected by the taxpayer) which would have been allowable for taxable years in the recovery period (determined after the application of section 280F (a) and paragraph (b) of this section and as if all use during the recovery period were used described in section 168(c)(1)).

(2) *Special rule when taxpayer elects to use the section 168(b)(3) optional recovery percentages*. If the taxpayer elects to use the optional recovery percentages under section 168(b)(3) or must use the straight line method over the earnings and profits life (as defined and described in §1.280F–3T(f)), the second succeeding taxable year after the end of the recovery period is treated as the first succeeding taxable year after the end of the recovery period for purposes of this paragraph (c) because of the half-year convention. For example, assume a calendar-year taxpayer places in service on July 1, 1984, a passenger automobile (*i.e.*, 3-year recovery property) and elects under section 168(b)(3) to recover its cost over 5 years using the straight line optional percentages. Based on these facts, calendar year 1990 is treated as the first succeeding taxable year after the end of the recovery period.

(3) *Deduction limited to $6,000 for any taxable year*. The amount that may be treated as a deductible expense under this paragraph (c) in the first taxable year succeeding the recovery period shall not exceed $6,000. Any excess shall be treated as an expense for the succeeding taxable years. However, in no event may any deduction in a succeeding taxable year exceed $6,000. The limitation on amounts deductible as an expense under this paragraph (c) with respect to any passenger automobile is increased by the automobile price inflation adjustment (as defined in section 280F(d)(7)) for the calendar year in which such automobile is placed in service.

(4) *Deduction treated as a section 168 recovery deduction*. Any amount allowable as an expense in a taxable year after the recovery period by reason of this paragraph (c) shall be treated as a recovery deduction allowable under section 168. However, a deduction is allowable by reason of this paragraph (c) with respect to any passenger automobile for a taxable year only to the extent that a deduction under section 168 would be allowable with respect to the automobile for that year. For example, no recovery deduction is allowable for a year during which a passenger automobile is disposed of or is used exclusively for personal purposes.

(d) *Additional reduction in limitations by reason of personal use of passenger automobile or by reason of a short taxable year*. See paragraph (i) of this section for rules regarding the additional reduction in the limitations prescribed by paragraphs (a) through (c) of this section by reason of the personal use of a passenger automobile or by reason of a short taxable year.

(e) *Examples*. The provisions of paragraphs (a) through (c) of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. (i) On July 1, 1984, B purchases for $45,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, B does not elect under section 179 to expense a portion of the cost of the automobile. The automobile is used exclusively in B's business during taxable years 1984 through 1990.

(ii) The maximum amount of B's investment tax credit is $1,000 (*i.e.*, the lesser of $1,000 or .06 × $45,000). B's unadjusted basis for purposes of section 168 is $44,500 (*i.e.*, $45,000 reduced under section 48(q)(1) by $500).

B selects the use of the accelerated recovery percentages under section 168(b)(1).

(iii) The maximum amount of B's recovery deduction for 1984 is $4,000 (*i.e*, the lesser of $4,000 or .25 × $44,500); for 1985, $6,000 (*i.e.*, the lesser of $6,000 or .38 × $44,500); and for 1986, $6,000 (*i.e.*, the lesser of $6,000 or .37 × $44,500).

(iv) At the beginning of taxable year 1987, B's unrecovered basis in the automobile is $28,500 (*i.e.*, $44,500 − $16,000). Under paragraph (c) of this section, B may expense $6,000 of the unrecovered basis in the automobile in 1987. This expense is treated as a recovery deduction under section 168. For taxable years 1988 through 1990, B may deduct $6,000 of the unrecovered basis per year. At the beginning of 1991, B's unrecovered basis in the automobile is $4,500. During that year, B disposes of the automobile. B is not allowed a deduction for 1991 because no deduction would be allowable under section 168 based on these facts.

Example 2. (i) On July 1, 1984, C purchases for $50,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in C's business during taxable years 1984 through 1992. In 1984, C does not elect under section 179 to expense a portion of the automobile's cost. C elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment.

(ii) The maximum amount of C's investment tax credit is $666.67 (*i.e.*, the lesser of ⅔ of $1,000 or .04 × $50,000). C's unadjusted basis for purposes of section 168 is $50,000. C elects to use the optional recovery percentages under section 168(b)(3) based on a 5-year recovery period.

(iii) The maximum amount of C's recovery deduction for 1984 is $4,000 (*i.e.*, the lesser of $4,000 or .10 × $50,000); for taxable years 1985 through 1988, $6,000 per year (*i.e.*, the lesser of $6,000 or .20 of $50,000). C's recovery deduction for 1989 is $5,000 (*i.e.*, the lesser of .10 × $50,000 or $6,000).

(iv) At the beginning of taxable year 1990, C's unrecovered basis in the automobile is $17,000. Under paragraph (c) of this section, C may expense $6,000 of the unrecovered basis in the automobile in 1990. this expense is treated as a recovery deduction under section 168. For taxable years 1991 and 1992, C may deduct $6,000, and $5,000, respectively of the unrecovered basis per year.

Example 3. Assume the same facts as in *Example 2,* except that C disposes of the passenger automobile on July 1, 1990. Under paragraph (c) of this section, C is not allowed a deduction for 1990 or for any succeeding taxable year because no deduction would be allowable under section 168 based on these facts.

Example 4. (i) On July 1, 1984, G purchases for $15,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in G's business during taxable years 1984 through 1987. In 1984, G elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of G's investment tax credit is $600 (*i.e.*, the lesser of .06 × $10,000 or $1,000).

(iii) G's unadjusted basis for purposes of section 168 is $9,700 (*i.e.*, $15,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $300 (one-half of the investment tax credit under section 48(q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of G's section 179 deduction is $4,000 (*i.e.*, the lesser of $4,000 or $5,000 + .25 × $9,700). G is entitled to no further recovery deduction under section 168 for 1984. The amount of G's 1985 and 1986 recovery deductions are $3,686 (*i.e.*, the lesser of .38 × $9,700 or $6,000) and $3,589 (*i.e.*, the lesser of .37 × $9,700 or $6,000), respectively. At the beginning of 1987, G's unrecovered basis in the automobile is $3,425 (*i.e.*, $14,700 − $11,275). Under paragraph (c) of this section, G may expense the remaining $3,425 in 1987.

Example 5. (i) On July 1, 1984, D purchases for $55,000 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusvely in D's business during taxable years 1984 through 1993. In 1984, D elects under section 179 to expense $5,000 of the cost of the property.

(ii) The maximum amount of D's investment tax credit is $1,000 (*i.e.*, the lesser of $1,000 or .06 × $50,000).

(iii) D's unadjusted basis for purposes of section 168 is $49,500 (*i.e.*, $55,000 minus the sum of $5,000 (the amount of the expense elected under section 179) and $500 (one-half of the investment tax credit under section 48 (q)(1))). Under paragraph (b)(4) of this section, the allowable deduction under section 179 is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of D's section 179 deduction is $4,000 (*i.e.*, the lesser of $4,000 or $5,000 + .25 × $49,500). D is entitled to no further recovery deduction under section 168 for 1984. The maximum amount of D's 1985 recovery deduction is $6,000 (*i.e.*, the lesser of $6,000 or .38 × $49,500); and for 1986, $6,000 (*i.e.*, the lesser of $6,000 or .37 of $49,500).

(iv) At the beginning of 1987, D's unrecovered basis is $38,500. D may expense the remaining unrecovered basis at the rate of $6,000 per year through 1992 and $2,500 in 1993.

Example 6. Assume the same facts as in *Example 5*, except that in 1993, D uses the automobile only 60 percent in his business. Under paragraph (c)(4) of this section for 1993, D may expense $1,500 (*i.e.*, .60 × $2,500). D is entitled to no further deductions with respect to the automobile in any later year.

Example 7. (i) On July 1, 1984, F purchases for $44,500 and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F's business during taxable years 1984 through 1992. In 1984, F elects under section 179 to expense $5,000 of the cost of the property.

(ii) F elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment. The maximum amount of F's investment tax credit is $666.67 (*i.e.*, the lesser of ⅔ of $1,000 or .04 × $39,500).

(iii) F's unadjusted basis for purposes of section 168 is $39,500 (*i.e.*, $44,500 − $5,000 (the amount of the expense elected under section 179)). F elects to use the optional recovery percentage under section 168(b)(3) based on a 5-year recovery period. Under paragraph (b)(4) of this section, the allowable section 179 deduction is treated as a recovery deduction under section 168 for purposes of this section. Thus, the maximum amount of F's section 179 deduction is $4,000 (*i.e.*, the lesser of $4,000 or $5,000 + .10 × $39,500). F is entitled to no further recovery deduction under section 168 for 1984. The maximum amounts of F's recovery deductions for 1985 through 1988 are $6,000 per year (*i.e.*, the lesser of $6,000 or .20 × $39,500). F's recovery deduction for 1989 (the first taxable year after the 5-year recovery period but the sixth recovery year for purposes of section 168) is $3,950 (*i.e.*, the lesser of .10 × $39,500 or $6,000).

(iv) Under paragraph (c), taxable year 1990 is considered to be the first taxable year succeeding the end of the recovery period. At the beginning of taxable year 1990, F's unrecovered basis in the automobile is $12,550 (*i.e.*, $44,500 − $31,950). Under paragraph (c), F may expense $6,000 of his unrecovered basis in the automobile in 1990 and in 1991. This expense is treated as a recovery deduction under section 168. For taxable year 1992, F may expense the remaining $550 of his unrecovered basis in the automobile.

(f) *Treatment of improvements that qualify as capital expenditures.* An improvement to a passenger automobile that qualifies as a capital expenditure under section 263 is treated as a new item of recovery property placed in service in the year the improvement is made. However, the limitations in paragraph (b) of this section on the amount of recovery deductions allowable are determined by taking into account as a whole both the improvement and the property of which the improvement is a part. If that improvement also qualifies as an investment in new section 38 property under section 48(b) and §1.48–2(b)(2), the limitation in paragraph (a)(1) of this section on the amount of the investment tax credit for that improvement is determined by taking into account any investment tax credit previously allowed for the passenger automobile (including any prior improvement considered part of the passenger automobile). Thus, the maximum credit allowable for the automobile (including the improvement) will be $1,000 (or ⅔ of $1,000, in the case of an election to take a reduced credit under section 48(q)(4)) (adjusted under section 280F(d)(7) to reflect the automobile price inflation adjustment for the year the property of which the improvement is a part is placed in service).

(g) *Treatment of section 1031 or section 1033 transactions*—(1) *Treatment of exchanged passenger automobile.* For a taxable year in which a transaction described in section 1031 or section 1033 occurs, the unadjusted basis of an exchanged or converted passenger automobile shall cease to be taken into account in determining any recovery deductions allowable under section 168 as of the beginning of the taxable year in which the exchange or conversion occurs. Thus, no recovery deduction is allowable for the exchanged or converted automobile in the year of the exchange or conversion.

(2) *Treatment of acquired passenger automobile*—(i) *In general.* The acquired automobile is treated as new property placed in service in the year of the exchange (or in the replacement year) and that year is its first recovery year.

(ii) *Limitations on recovery deductions.* If the exchanged (or converted) automobile was acquired after the effective date of section 280F (as set out in §1.280F–1(c)), the basis of that automobile as determined under section 1031(d) or section 1033(b) (whichever is applicable) must be reduced for purposes of computing recovery deductions with respect to the acquired automobile (but not for purposes of determining the amount of the investment tax credit and gain or loss on the sale or other disposition of the property) by the excess (if any) of:

(A) The sum of the amounts that would have been allowable as recovery deductions with respect to the exchanged (or converted) automobile during taxable years preceding the year of the exchange (or conversion) if all of the use of the automobile during those years was use described in section 168(c), over

(B) The sum of the amounts allowable as recovery deductions during those years.

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

Example 1. (i) In 1982, F purchases and places in service a passenger automobile which is 3-year recovery property under section 168. The automobile is used exclusively in F's business.

(ii) On July 1, 1984, F exchanges the passenger automobile and $1,000 cash for a new passenger automobile (''like kind'' property). Under paragraph (g)(1) of this section, no recovery deduction is allowed in 1984 for the exchanged automobile. Any investment tax credit claimed with respect to that automobile is subject to recapture under section 47.

(iii) F's basis in the acquired property (as determined under section 1031(d) and F's qualified investment are $20,000. Under the provisions of paragraph (g)(2)(i) of this section, the acquired property is treated as new recovery property placed in service in 1984 to the extent of the full $20,000 of basis. The maximum amount of F's investment tax credit is limited to $1,000 (*i.e.*, the lesser of $1,000 or .06 × $20,000). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

Example 2. (i) On July 1, 1984, E purchases for $30,000 and places in service a passenger automobile which is 3-year recovery property under section 168. In 1984, E's business use percentage is 80 percent and such use constitutes his total business/investment use.

(ii) E elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48 (q)(1) basis adjustment. The maximum amount of E's investment tax credit is $533.33 (*i.e.*, the lesser of ⅔ of $1,000 × .80 or .80 × .04 × $30,000).

(iii) E's unadjusted basis for purposes of section 168 is $30,000. E selects the use of the accelerated recovery percentages under section 168(b)(1). The maximum amount of E's recovery deduction for 1984 is $3,200 (*i.e.*, the lesser of .80 × $4,000 or .80 × .25 × $30,000).

(iv) On June 10, 1985, E exchanges the passenger automobile and $1,000 cash for a new passenger automobile (''like kind'' property). Under paragraph (g)(1) of this section, no recovery deduction is allowable in 1985 for the exchanged automobile. The investment tax credit claimed is subject to recapture under section 47. Under paragraph (g)(2)(ii) of this section, E's basis in the acquired property for purposes of computing recovery deductions under section 280F is $27,000 (*i.e.*, $27,800 (section 1031(d) basis) − $800). The acquired automobile is used exclusively in F's business during taxable years 1985 through 1988. Under paragraph (g)(2) of this section, the acquired property is treated as new recovery property placed in service in 1985. Assume that the automobile price inflation adjustment (as described under section 280F(d)(7)) is zero. E's qualified investment in the property, as determined under §1.46–3(c)(1), is $27,800. The maximum amount of E's investment tax credit is $1,000 (*i.e.*, the lesser of $1,000 or .06 × $27,800). E's unadjusted basis for purposes of section 168 is $26,500 (*i.e.*, $27,000 reduced under section 48(q)(1) by $500). Cost recovery deductions are computed pursuant to paragraph (b) of this section.

(h) *Other nonrecognition transactions.* [Reserved]

(i) *Limitation under this section applies before other limitations*—(1) *Personal use.* The limitations imposed upon the maximum amount of the allowable investment tax credit and the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer makes any use of a passenger automobile other than for business/investment use (as defined in §1.280F–6(d)(3)). The limitations on the amount of the allowable investment tax credit (as described in paragraph (a) of this section) and the allowable cost recovery deductions (as described in paragraphs (b) and (c) of this section) are redetermined by multiplying the limitations by the percentage of business/investment use (determined on an annual basis) during the taxable year.

(2) *Short taxable year.* The limitations imposed upon the maximum amount of the allowable recovery deductions (as described in paragraphs (a) through (c) of this section) must be adjusted during any taxable year in which a taxpayer has a short taxable year. In this case, the limitation is adjusted by multiplying the limitation that would have been applied if the taxable year were not a short taxable year by a fraction, the numerator of which is the number of months and part-months in the short

taxable year and the denominator of which is 12.

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

Example 1. On July 1, 1984, A purchases and places in service a passenger automobile and uses it 80 percent for business/investment use during 1984. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is \$800 (*i.e.*, .80 × \$1,000).

Example 2. Assume the same facts as in *Example 1*, except that A elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the section 48(q)(1) basis adjustment. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that A may claim for the automobile is \$533.33 (*i.e.*, .80 × ⅔ × \$1,000).

Example 3. On July 1, 1984, B purchases and places in service a passenger automobile and uses it 60 percent for business/investment use during 1984. Under paragraph (i)(1) of this section, the maximum amount of the investment tax credit that B may claim for the automobile is \$600 (*i.e.*, .60 × \$1,000). B uses the car 70 percent for business/investment use during 1985 and 80 percent during 1986. Under paragraph (i)(1) of this section, the maximum amount of recovery deductions that B may claim for 1984, 1985, and 1986 are \$2,400 (*i.e.*, .60 × \$4,000), \$4,200 (*i.e.*, .70 × \$6,000), and \$4,800 (*i.e.*, .80 × \$6,000), respectively.

Example 4. Assume the same facts as in *Example 3* with the added facts that B's unrecovered basis at the beginning of 1987 is \$6,000 and that B uses the automobile 85 percent for business/investment use during 1987. Under paragraph (i)(1) of this section, the maximum amount that B may claim as an expense for 1987 is \$5,000 (*i.e.*, .85 × \$6,000).

Example 5. On August 1, 1984, C purchases and places in service a passenger automobile and uses it exclusively for business. Taxable year 1984 for C is a short taxable year which consists of 6 months. Under paragraph (i)(2) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is \$2,000 (*i.e.*, 6⁄12 × \$4,000).

Example 6. Assume the same facts as in *Example 5*, except that C uses the passenger automobile 70 percent for business/investment use during 1984. Under paragraph (i) (1) and (2) of this section, the maximum amount that C may claim as a recovery deduction for 1984 is \$1,400 (*i.e.*, .70 × 6⁄12 × \$4,000).

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42704, Oct. 24, 1984, as amended by T.D. 9133, 69 FR 35514, June 25, 2004]

§ 1.280F–3T Limitations on recovery deductions and the investment tax credit when the business use percentage of listed property is not greater than 50 percent (temporary).

(a) *In general.* Section 280F(b), generally, imposes limitations with respect to the amount allowable as an investment tax credit under section 46(a) and the amount allowable as a recovery deduction under section 168 in the case of listed property (as defined in § 1.280F–6(b)) if certain business use of the property (referred to as ''qualified business use'') does not exceed 50 percent during a taxable year. *Qualified business use* generally means use in a trade or business, rather than use in an investment or other activity conducted for the production of income within the meaning of section 212. See § 1.280F–6(d) for the distinction between ''business/investment use'' and ''qualified business use.''

(b) *Limitation on the amount of investment tax credit*—(1) *Denial of investment tax credit when business use percentage not greater than 50 percent.* Listed property is not treated as section 38 property to any extent unless the business use percentage (as defined in section 280F(d)(6) and § 1.280F–6(d)(1)) is greater than 50 percent. For example, if a taxpayer uses listed property in a trade or business in the taxable year in which it is placed in service, but the business use percentage is not greater than 50 percent, no investment tax credit is allowed for that listed property. If, in the taxable year in which listed property is placed in service, the only business/investment use (as defined in § 1.280F–6(d)(3)) of that property is qualified business use (as defined in § 1.280F–6(d)(2)(i)), and the business use percentage is 55 percent, the investment tax credit is allowed for the 55 percent of the listed property that is treated as section 38 property. The credit allowed is unaffected by any increase in the business use percentage in a subsequent taxable year.

(2) *Recapture of investment tax credit.* Listed property ceases to be section 38 property to the extent that the business/investment use (as defined in § 1.280F–6(d)(3)) for any taxable year is less than the business/investment use

for the taxable year in which the property is placed in service. *See* §1.47–2(c). If the business use percentage (as defined in §1.280F–6(d)(1)) of listed property is greater than 50 percent for the taxable year in which the property is placed in service, and less than or equal to 50 percent for any subsequent taxable year, that property ceases to be section 38 property in its entirety in that subsequent taxable year. Under §1.47–1(c)(1)(ii)(*b*), the property (or a portion thereof) is treated as ceasing to be section 38 property on the first day of the taxable year in which the cessation occurs.

(c) *Limitation on the method of cost recovery under section 168 when business use of property not greater than 50 percent*—(1) *Year of acquisition.* If any listed property (as defined in §1.280F–6(b)) is not predominantly used in a qualified business use (as defined in §1.280F–6(d)(4)) in the year it is acquired, the recovery deductions allowed under section 168 for the property for that taxable year and for succeeding taxable years are to be determined using the straight line method over its earnings and profits life (as defined in paragraph (f) of this section). Additionally, the taxpayer is not entitled to make any election under section 179 with respect to the property for that year.

(2) *Subsequent years.* If any listed property is not subject to paragraph (c)(1) of this section because such property is predominantly used in a qualified business use (as defined in §1.280F–6(d)(4)) during the year it is acquired but is not predominantly used in a qualified business use during a subsequent taxable year, the rules of this paragraph (c)(2) apply. In such a case, the taxpayer must determine the recovery deductions allowed under section 168 for the taxable year that the listed property is not predominantly used in a qualified business use and for any subsequent taxable year as if such property was not predominantly used in a qualified business use in the year in which it was acquired and there had been no section 179 election with respect to the property. Thus, the recovery deductions allowable under section 168 for the remaining taxable years are computed by determining the applicable recovery percentage that would apply if the taxpayer had used the straight line method over the property's earnings and profits life beginning with the year the property was placed in service.

(3) *Effect of rule on recovery property that is not listed property.* The mandatory use of the straight line method over the property's earnings and profits life under paragraphs (d) (1) and (2) of this section does not have any effect on the proper method of cost recovery for other recovery property of that same class placed in service in the same taxable year by the taxpayer and does not constitute an election to use an optional recovery period under section 168(b)(3).

(d) *Recapture of excess recovery deductions claimed*—(1) *In general.* If paragraph (c)(2) of this section is applicable, any excess depreciation (as defined in paragraph (d)(2) of this section) must be included in the taxpayer's gross income and added to the property's adjusted basis for the first taxable year in which the property is not predominantly used in a qualified business use (as defined in §1.280F–6(d)(4)).

(2) *Definition of excess depreciation.* For purposes of this section, the term *excess depreciation* means the excess (if any) of:

(i) The amount of the recovery deductions allowable with respect to the property for taxable years before the first taxable year in which the property was not predominantly used in a qualified business use, over

(ii) The amount of the recovery deductions which would have been allowable for those years if the property had not been predominantly used in a qualified business use for the year it was acquired and there had been no section 179 election with respect to the property.

For purposes of paragraph (d)(2)(i), any deduction allowable under section 179 (relating to the election to expense certain depreciable trade or business assets) is treated as if that deduction was a recovery deduction under section 168.

(3) *Recordkeeping requirement.* A taxpayer must be able to substantiate the use of any listed property, as prescribed in section 274(d)(4) and §1.274–5T or §1.274–6T, for any taxable year for which recapture under section

280F(b)(3) and paragraph (d) (1) and (2) of this section may occur even if the taxpayer has fully depreciated (or expensed) the listed property in a prior year. For example, in the case of 3-year recovery property, the taxpayer shall maintain a log, journal, etc. for six years even though the taxpayer fully depreciated the property in the first three years.

(e) *Earnings and profits life*—(1) *Definition*. The earnings and profits life with respect to any listed property is generally the following:

In the case of—	The applicable recovery period is—
3-year property	5 years.
5-year property	12 years.
10-year property	25 years.
18-year real property and low-income housing	40 years.
15-year public utility property	35 years.

However, if the recovery period applicable to any recovery property under section 168 is longer than the above assigned recovery period, such longer recovery period shall be used. For example, generally, the recovery period for recovery property used predominantly outside the United States is the property's present class life (as defined in section 168(g)(2)). In many cases, a property's present class life is longer than the recovery period assigned to the property under the above table. Pursuant to this paragraph (e)(1), the property's recovery period is its present class life.

(2) *Applicable recovery percentages*. If the applicable recovery period is determined pursuant to the table prescribed in paragraph (e)(1) of this section, the applicable recovery percentage is:

(i) For property other than 18-year real property or low-income housing:

If the recovery year is—	And the recovery period is—			
	5	12	25	35
1	10	4	2	1
2	20	9	4	3
3	20	9	4	3
4	20	9	4	3
5	10	8	4	3
7	....	8	4	3
8	....	8	4	3
9	....	8	4	3
10	....	8	4	3
11	....	8	4	3
12	....	8	4	3
13	....	4	4	3
14	....	....	4	3
15	....	....	4	3
16	....	....	4	3
17	....	....	4	3
18	....	....	4	3
19	....	....	4	3
20	....	....	4	3
21	....	....	4	3
22	....	....	4	3
23	....	....	4	3
24	....	....	4	3
25	....	....	4	3
26	....	....	2	3
27	....	....	....	3
28	....	....	....	3
29	....	....	....	3
30	....	....	....	3
31	....	....	....	3
32	....	....	....	2
33	....	....	....	2
34	....	....	....	2
35	....	....	....	2
36	....	....	....	1

(ii) For 18-year real property: [Reserved]

(iii) For low-income housing: [Reserved]

(f) *Examples*. The provisions of this section may be illustrated by the following examples. For purposes of these examples, assume that all taxpayers use the calendar year and that no short taxable years are involved.

Example 1. On July 1, 1984, B purchases for $50,000 and places in service an item of listed property (other than a passenger automobile) which is 3-year recovery property under section 168. For the first taxable year that the property is in service, B used the property 40 percent in a trade or business, 40 percent for the production of income, and 20 percent for personal purposes. Although B's total business/investment use is greater than 50 percent, the business use percentage for that taxable year is only 40 percent. Under paragraph (b)(1) of this section, no investment tax credit is allowed for the property.

Example 2. (i) On January 1, 1985, C purchases for $40,000 and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property under section 168. Seventy percent of the use of the property is in C's trade or business and 30 percent of the use is for personal purposes. C does not elect a reduced investment tax credit under section 48(q)(4). The amount of C's investment tax credit is $1,680 (*i.e.*, $40,000 × .60 × .10 × .70).

(ii) In addition, in 1986, only 55 percent of the use of the property is in C's trade or business and 45 percent of the use is for personal purposes. Under paragraph (b)(2) of this section, the property ceases to be section 38 property to the extent that the use in a trade or business decreased below 70 percent. As a result, a portion of the investment tax credit must be recaptured as an increase in tax liability for 1986 under the rules of section 47 (relating to the recapture of investment tax credit). *See* section 47(a)(5) and §1.47–2(e) for rules relating to the computation of the recapture amount.

Example 3. On July 1, 1984, B purchases and places in service an item of listed property (other than a passenger automobile) that is 3-year recovery property. B elects to take a reduced investment tax credit under section 48(q)(4). In 1984, B uses the property exclusively in his business. Assume that B's 1984 allowable recovery deduction is $12,500. In 1985 and 1986, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, B must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (*i.e.*, its earnings and profits life) using the straight line method (with the half-year convention) from the time it was placed in service. Therefore, taxable year 1985 is treated as the property's second recovery year (of its 5-year recovery period) and the applicable recovery deduction using the straight line method must be used to determine the recovery deduction. Under paragraph (d) of this section, B must recapture any excess depreciation claimed for taxable year 1984. If B had used the straight line method over a 5-year recovery period his recovery deduction for 1984 would have been $5,000. Under paragraph (d)(2) of this section, B's excess depreciation is $7,500 (*i.e.*, $12,500 − $5,000) and that amount must be included in B's 1985 gross income and added to the property's basis. The taxable years 1986 through 1989 are the property's second through sixth recovery years, respectively, of such property's 5-year recovery period.

Example 4. Assume the same facts as in *Example 3*, except that in 1986 B used the property exclusively in his business. B is entitled to no investment tax credit with respect to the property in 1986 and must continue to recover the property's cost over a 5-year recovery period using the straight line method.

Example 5. On July 1, 1984, H purchases and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. H selects the use of the accelerated recovery percentages under section 168. In 1984 through 1986, H uses the property exclusively for business. In 1987, the property is not predominantly used in a qualified business use. Under paragraph (c)(2) of this section, H must compute his 1987 and subsequent taxable year's recovery deductions using the straight line method over a 5-year recovery period with 1987 treated as the fourth recovery year. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986 even though by 1987 the full cost of the property had already been recovered.

Example 6. Assume the same facts as in *Example 5*, except that H uses the property exclusively for personal purposes in 1987. Under paragraph (d) of this section, H must recapture any excess depreciation claimed for taxable years 1984 through 1986. H is entitled to no cost recovery deduction under the 5-year straight line method for 1987. Assume further that in 1988 H uses the property 70 percent in his business. Thus, H's business use percentage for that year is 70 percent. Under paragraph (c)(2) of this section, H must compute his 1988 cost recovery deduction using the straight line method over a 5-year recovery period with 1988 treated as the fifth recovery year.

Example 7. (i) On July 1, 1984, F purchases for $70,000 and places in service listed property (other than a passenger automobile) which is 3-year recovery property under section 168. F's business use percentage for 1984 through 1986 is 60 percent. F elects under section 179 to expense $5,000 of the cost of the property.

(ii) F elects a reduced investment tax credit under section 48(q)(4). The maximum amount of F's investment tax credit is $1,560 (*i.e.*, $65,000 × .04 × .60).

(iii) F's unadjusted basis for purposes of section 168 is $65,000 (*i.e.*, $70,000 reduced by the $5,000 section 179 expense). F selects the use of the accelerated recovery percentages under section 168(b)(1). F's recovery deduction for 1984 is $9,750 (*i.e.*, $65,000 × .25 × .60).

(iv) In 1985, the property is not predominantly used in a qualified business use. The investment tax credit claimed is subject to recapture in full under section 47 in 1985 since the property ceases to be section 38 property in its entirety on January 1, 1985. Under paragraph (c)(2) of this section, F must treat the property for 1985 and subsequent taxable years as if he recovered its cost over a 5-year recovery period (*i.e.*, its earnings and profits life) using the straight line method (with the half year convention) from the time it was placed in service. Under paragraph (d) of this section, F must recapture any excess depreciation claimed for taxable year 1984. F's excess depreciation is $10,550 [*i.e.*, ($65,000 × .25 × .60 + $5,000) − ($70,000 × .10 × .60)]. This amount must be included in F's 1985 gross income and added to the property's adjusted basis.

Example 8. (i) On July 1, 1984, G purchases for $60,000 and places in service a passenger automobile which is 3-year recovery property under section 168.

(ii) In 1984, G's business use percentage is 80 percent and such use constitutes his total business/investment use. G elects under section 48(q)(4) to take a reduced investment tax credit in lieu of the basis adjustment under section 48(q)(1). The maximum amount of G's investment tax credit is $533.33 (*i.e.*, the lesser of .80 × ⅔ × $1,000 or $60,000 × .80 × .04).

(iii) In 1984, G does not elect under section 179 to expense a portion of the automobile's cost. G selects the use of the accelerated recovery percentages under section 168. G's unadjusted basis for purposes of section 168 is $60,000. The maximum amount of G's 1984 recovery deduction is $3,200 (*i.e.*, the lesser of .80 × $4,000 or .80 × .25 × $60,000).

(iv) In 1985, G's business use percentage is 80 percent and such use constitutes his total business/investment use. The maximum amount of G's 1985 recovery deduction is $4,800 (*i.e.*, the lesser of .80 × $6,000 or .80 × .38 × $60,000).

(v) In 1986, G's business use percentage is 45 percent and such use constitutes his total business/investment use. Under paragraph (b)(2) of this section, as a result of the decline in the business use percentage to 50 percent or less, the automobile ceases to be section 38 property in its entirety and G must recapture (pursuant to §§ 1.47–1(c) and 1.47–2(e)) the investment tax credit previously claimed. Since G's business use percentage in 1986 is not greater than 50 percent, under the provisions of paragraph (d) of this section, G must recompute (for recapture purposes) his recovery deductions for 1984 and 1985 using the straight line method over a 5-year recovery period (*i.e.*, earnings and profits life for 3-year recovery property using the half-year convention) to determine if any excess depreciation must be included in his 1986 taxable income. G's recomputed recovery deductions for 1984 and 1985 are $3,200 (*i.e.*, the lesser of .80 × $4,000 or .80 × .10 × $60,000), and $4,800 (*i.e.*, the lesser of .80 × $6,000 or .80 × .20 × $60,000), respectively. G does not have to recapture any excess depreciation since his recovery deductions for 1984 and 1985 computed using the straight line method over a 5-year recovery period are the same as the amounts actually claimed during those years.

(vi) Under paragraph (c)(2) of this section, for 1986 and succeeding taxable years G must compute his remaining recovery deductions using the straight line method over a 5-year recovery period beginning with the third recovery year. The maximum amount of G's 1986 recovery deduction is $2,700 (*i.e.*, the lesser of .45 × $6,000 or .45 × .20 × $60,000). For taxable years 1987 through 1993, G's business use percentage is 55 percent and such use constitutes his total business/investment use. G's 1987 and 1988 recovery deductions are $3,300 per year (*i.e.*, the lesser of .55 × $6,000 or .55 × .20 × $60,000). For taxable year 1989 (the last recovery year), G's recovery deduction is $3,300 (*i.e.*, .55 × .10 × $60,000 or .55 × $6,000).

(vii) As of the beginning of 1990, G will have claimed a total of $20,600 of recovery deductions. Under § 1.280F–2T(c), G may expense his remaining unrecovered basis (up to a certain amount per year) in the first succeeding taxable year after the end of the recovery period and in taxable years thereafter. If G had used his automobile for 100 percent business use in taxable years 1984 through 1989, G could have claimed a recovery deduction of $4,000 in 1984 and a recovery deduction of $6,000 in each of those remaining years. At the beginning of 1990, therefore, G's unrecovered basis (as defined in section 280F(d)(8)) is $26,000 (*i.e.*, $60,000 − $34,000). The maximum amount of G's 1990 recovery deduction is $3,300 (*i.e.*, .55 × $6,000). At the beginning of 1991, G's unrecovered basis is $20,000 (*i.e.*, $26,000 adjusted under section 280F(d)(2) and § 1.280F–4T(a) to account for the amount that would have been claimed in 1990 for 100 percent business/investment use during that year). The maximum amount of G's 1991 recovery deduction is $3,300 (*i.e.*, .55 × $6,000) and his unrecovered basis as of the beginning of 1992 is $14,000 (*i.e.*, $20,000 − $6,000). In 1992, G disposes of the automobile. G is not allowed a recovery deduction for 1992.

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42707, Oct. 24, 1984, as amended by T.D. 8061, 50 FR 46038, Nov. 6, 1985; T.D. 9133, 69 FR 35514, June 25, 2004]

§ 1.280F–4T Special rules for listed property (temporary).

(a) *Limitations on allowable recovery deductions in subsequent taxable years*—(1) *Subsequent taxable years affected by reason of personal use in prior years.* For purposes of computing the amount of the recovery deduction for ''listed property'' for a subsequent taxable year, the amount that would have been allowable as a recovery deduction during an earlier taxable year if all of the use of the property was use described in section 168(c) is treated as the amount of the recovery deduction allowable during that earlier taxable year. The preceding sentence applies with respect to all earlier taxable years, beginning with the first taxable year in which some or all use of the ''listed property'' is use described in section 168(c). For example, on July 1, 1984, B purchases and places in service listed property (other than a passenger automobile) which is 5-year recovery property under section 168. B selects the use of the accelerated percentages under section 168. B's business/investment use of the property (all of which is qualified business use as defined in section 280F(d)(6)(B) and §1.280F–6(d)(2)) in 1984 through 1988 is 80 percent, 70 percent, 60 percent, and 55 percent, respectively, and B claims recovery deductions for those years based on those percentages. B's qualified business use for the property for 1989 and taxable years thereafter increases to 100 percent. Pursuant to this rule, B may not claim a recovery deduction in 1989 (or for any subsequent taxable year) for the increase in business use because there is no adjusted basis remaining to be recovered for cost recovery purposes after 1988.

(2) *Special rule for passenger automobiles.* In the case of a passenger automobile that is subject to the limitations of §1.280F–2T, the amount treated as the amount that would have been allowable as a recovery deduction if all of the use of the automobile was use described in section 168(c) shall not exceed $4,000 for the year the passenger automobile is placed in service and $6,000 for each succeeding taxable year (adjusted to account for the automobile price inflation adjustment, if any, under section 280F(d)(7) and for short taxable year under §1.280F–2T(i)(2)). *See.* §1.280F–3T(g). *Example 8.*

(b) *Treatment of improvements that qualify as capital expenditures*—(1) *In general.* In the case of any improvement that qualifies as a capital expenditure under section 263 made to any listed property other than a passenger automobile, the rules of this paragraph (b) apply. See §1.280F–2T(f) for the treatment of an improvement made to a passenger automobile.

(2) *Investment tax credit allowed for the improvement.* If the improvement qualifies as an investment in new section 38 property under section 48(b) and §1.48–2(b), the investment tax credit for that improvement is limited by paragraph (b)(1) of §1.280F–3T, as applied to the item of listed property as a whole.

(3) *Cost recovery of the improvement.* The improvement is treated as a new item of recovery property. The method of cost recovery with respect to that improvement is limited by §1.280F–3T(c), as applied to the item of listed property as a whole.

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

[T.D. 7986, 49 FR 42710, Oct. 24, 1984, as amended by T.D. 9133, 69 FR 35514, June 25, 2004]

§1.280F–5T Leased property (temporary).

(a) *In general.* Except as otherwise provided in this section, the limitation on cost recovery deductions and the investment tax credit provided in section 280F (a) and (b) and §§1.280F–2T and 1.280F–3T do not apply to any listed property leased or held for leasing by any person regularly engaged in the business of leasing listed property. If a person is not regularly engaged in the business of leasing listed property, the limitations on cost recovery deductions and the investment tax credit provided in section 280F and §§1.280F–2T and 1.280F–3T apply to such property leased or held for leasing by such person. The special rules for lessees set out in this section apply with respect to all lessees of listed property, even those whose lessors are not regularly engaged in the business of leasing listed property. For rules on determining inclusion amounts with respect to passenger automobiles, see paragraphs (d), (e) and (g) of this section, and see §1.280F–7(a). For rules on determining inclusion amounts with respect to other listed property, see paragraphs (f) and (g) of this section, and see §1.280F–7(b).

(b) *Section 48(d) election.* If a lessor elects under section 48(d) with respect to any listed property to treat the lessee as having acquired such property, the amount of the investment tax credit allowed to the lessee is subject to the limitation prescribed in §1.280F–3T(b) (1) and (2). If a lessor elects under section 48(d) with respect to any passenger automobile to treat the lessee as having acquired such automobile, the amount of the investment tax credit allowed to the lessee is also subject to the limitations prescribed in §1.280F–2T (a) and (i).

(c) *Regularly engaged in the business of leasing.* For purposes of paragraph (a) of this section, a person shall be considered regularly engaged in the business of leasing listed property only if contracts to lease such property are entered into with some frequency over a continuous period of time. The determination shall be made on the basis of the facts and circumstances in each case, taking into account the nature of the person's business in its entirety. Occasional or incidental leasing activity is insufficient. For example, a person leasing only one passenger automobile during a taxable year is not regularly engaged in the business of leasing automobiles. In addition, an employer that allows an employee to use the employer's property for personal purposes and charges such employee for the use of the property is not regularly engaged in the business of leasing with respect to the property used by the employee.

(d) *Inclusions in income of lessees of passenger automobiles leased after June 18, 1984, and before April 3, 1985*—(1) *In general.* If a taxpayer leases a passenger automobile after June 18, 1984, but before April 3, 1985, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount (prorated for the number of days of the lease term included in that taxable year), determined under this paragraph (d)(1), and multiplied by the business/investment use (as defined in §1.280F–6(d)(3)(i)) for the particular taxable year. The inclusion amount:

(i) Is 7.5 percent of the excess (if any) of the automobile's fair market value over $16,500 for each of the first three taxable years during which a passenger automobile is leased.

(ii) Is 6 percent of the excess (if any) of the automobile's fair market value over $22,500 for the fourth taxable year during which a passenger automobile is leased.

(iii) Is 6 percent of the excess (if any) of the automobile's fair market value over $28,500 for the fifth taxable year during which a passenger automobile is leased.

(iv) Is 6 percent of the excess (if any) of the automobile's fair market value over $34,500 for the sixth taxable year during which a passenger automobile is leased.

For the seventh and subsequent taxable years during which a passenger automobile is leased, the inclusion amount is 6 percent of the excess (if any) of the automobile's fair market value over the sum of (A) $16,500 and (B) $6,000 multiplied by the number of such taxable years in excess of three years. *See* paragraph (g)(2) of this section for the definition of fair market value.

(2) *Additional inclusion amount when less than predominant use in a qualified business use.* (i) If a passenger automobile, which is leased after June 18, 1984, and before April 3, 1985, is not used predominantly in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (d)(2). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (d)(1) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $16,500, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (d)(2)(iii) of this section. If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is $16,500 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (d)(2)(iv) of this section.

(iii) The dollar amount is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The dollar amount:			
	Lease term (years)			
	1	2	3	4 or more
The first taxable year of the lease term	$350	$700	$1,350	$1,850
The second taxable year of the lease term	....	....	650	1,250
The third taxable year of the lease term	....	....	....	650

(iv) The applicable percentage is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The applicable percentage:			
	Lease term (years)			
	1	2	3	4 or more
The first taxable year of the lease term	3.0	6.0	10.2	13.2
The second taxable year of the lease term	....	1.25	6.2	10.4
The third taxable year of the lease term	....	....	2.25	6.5
The fourth taxable year of the lease term	....	....	....	1.7
The fifth taxable year of the lease term	....	....	....	0.5

(e) *Inclusions in income of lessees of passenger automobiles leased after April 2, 1985, and before January 1, 1987*—(1) *In general*. For any passenger automobile that is leased after April 2, 1985, and before January 1, 1987, for each taxable year (except the last taxable year) during which the taxpayer leases the automobile, the taxpayer must include in gross income an inclusion amount determined under subparagraphs (2) through (5) of this paragraph (e). Additional inclusion amounts when a passenger automobile is not used predominantly in a qualified business use during a taxable year are determined under paragraph (e)(6) of this section. *See* paragraph (h)(2) of this section for the definition of fair market value.

(2) *Fair market value not greater than $50,000: years one through three*. For any passenger automobile that has a fair market value not greater than $50,000, the inclusion amount for each of the first three taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(2)(iv) of this section, select the dollar amount from the column for the quarter of the taxable year in which the automobile is first used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(iii) Multiply the prorated dollar amount by the business/investment use for the taxable year.

(iv) *Dollar amounts: Years 1–3:*

DOLLAR AMOUNTS: YEARS 1–3

Fair market value		Taxable year quarter			
Greater than—	But not greater than—	4th	3d	2d	1st
$11,250	$11,500	$8	$7	$6	$6
11,500	11,750	24	21	19	17
11,750	12,000	40	35	32	29
12,000	12,250	56	49	44	40
12,250	12,500	72	64	57	52
12,500	12,750	88	78	70	63
12,750	13,000	104	92	83	75
13,000	13,250	120	106	95	86
13,250	13,500	144	128	115	104
13,500	13,750	172	153	137	124
13,750	14,000	200	177	159	145
14,000	14,250	228	202	182	165
14,250	14,500	256	227	204	185
14,500	14,750	284	252	226	206
14,750	15,000	312	277	249	226
15,000	15,250	340	302	271	246
15,250	15,500	369	327	293	266
15,500	15,750	397	352	316	287
15,750	16,000	425	377	338	307
16,000	16,250	453	402	360	327
16,250	16,500	481	426	383	348
16,500	16,750	509	451	405	368
16,750	17,000	537	476	428	388
17,000	17,500	579	514	461	419
17,500	18,000	635	563	506	459
18,000	18,500	691	613	550	500
18,500	19,000	748	663	595	541
19,000	19,500	804	713	640	581
19,500	20,000	860	763	685	622
20,000	20,500	916	812	729	662
20,500	21,000	972	862	774	703
21,000	21,500	1,028	912	819	744
21,500	22,000	1,084	962	863	784
22,000	23,000	1,169	1,036	930	845
23,000	24,000	1,281	1,136	1,020	926
24,000	25,000	1,393	1,236	1,109	1,007
25,000	26,000	1,506	1,335	1,199	1,089
26,000	27,000	1,618	1,435	1,288	1,170
27,000	28,000	1,730	1,534	1,377	1,251
28,000	29,000	1,842	1,634	1,467	1,332
29,000	30,000	1,955	1,734	1,556	1,413
30,000	31,000	2,067	1,833	1,646	1,495
31,000	32,000	2,179	1,933	1,735	1,576
32,000	33,000	2,292	2,032	1,824	1,657
33,000	34,000	2,404	2,132	1,914	1,738

DOLLAR AMOUNTS: YEARS 1–3—Continued

Fair market value		Taxable year quarter			
Greater than—	But not greater than—	4th	3d	2d	1st
34,000	35,000	2,516	2,232	2,003	1,819
35,000	36,000	2,629	2,331	2,093	1,901
36,000	37,000	2,741	2,431	2,182	1,982
37,000	38,000	2,853	2,530	2,271	2,063
38,000	39,000	2,965	2,630	2,361	2,144
39,000	40,000	3,078	2,730	2,450	2,225
40,000	41,000	3,190	2,829	2,540	2,307
41,000	42,000	3,302	2,929	2,629	2,388
42,000	43,000	3,415	3,028	2,718	2,469
43,000	44,000	3,527	3,128	2,808	2,550
44,000	45,000	3,639	3,228	2,897	2,631
45,000	46,000	3,752	3,327	2,987	2,713
46,000	47,000	3,864	3,427	3,076	2,794
47,000	48,000	3,976	3,526	3,165	2,875
48,000	49,000	4,088	3,626	3,255	2,956
49,000	50,000	4,201	3,726	3,344	3,037

(3) *Fair market value not greater than $50,000: years four through six.* For any passenger automobile that has a fair market value greater than $18,000, but not greater than $50,000, the inclusion amount for the fourth, fifth, and sixth taxable years during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the table in paragraph (e)(3)(iv) of this section, select the dollar amount from the column for the taxable year in which the automobile is used under the lease,

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(iii) Multiply this dollar amount by the business/investment use for the taxable year.

(iv) Dollar Amounts: Years 4–6:

DOLLAR AMOUNTS: YEARS 4–6

Fair market value		Year		
Greater than—	But not greater than—	4	5	6
$18,000	$18,500	$15	....	....
18,500	19,000	45	....	....
19,000	19,500	75	....	....
19,500	20,000	105	....	....
20,000	20,500	135	....	....
20,500	21,000	165	....	....
21,000	21,500	195	....	....
21,500	22,000	225	....	....
22,000	23,000	270	....	....
23,000	24,000	330	$42	....
24,000	25,000	390	102	....
25,000	26,000	450	162	....
26,000	27,000	510	222	....
27,000	28,000	570	282	....
28,000	29,000	630	342	$54
29,000	30,000	690	402	114
30,000	31,000	750	462	174
31,000	32,000	810	522	234
32,000	33,000	870	582	294
33,000	34,000	930	642	354
34,000	35,000	990	702	414
35,000	36,000	1,050	762	474
36,000	37,000	1,110	822	534
37,000	38,000	1,170	882	594
38,000	39,000	1,230	942	654
39,000	40,000	1,290	1,002	714
40,000	41,000	1,350	1,062	774
41,000	42,000	1,410	1,122	834
42,000	43,000	1,470	1,182	894
43,000	44,000	1,530	1,242	954
44,000	45,000	1,590	1,302	1,014
45,000	46,000	1,650	1,362	1,074
46,000	47,000	1,710	1,422	1,134
47,000	48,000	1,770	1,482	1,194
48,000	49,000	1,830	1,542	1,254
49,000	50,000	11,890	1,602	1,314

(4) *Fair market value greater than $50,000: years one through six.* (i) For any passenger automobile that has a fair market value greater than $50,000, the inclusion amount for the first six taxable years during which the automobile is leased is determined as follows:

(A) Determine the dollar amount by using the appropriate formula in paragraph (e)(4)(ii) of this section,

(B) Prorate the dollar amount for the number of days of the lease term included in the taxable year, and

(C) Multiply this dollar amount by the business/investment use for the taxable year.

(ii) The dollar amount is computed as follows:

(A) If the automobile is first used under the lease in the fourth quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $124, and

(*2*) 11 percent of the excess of the automobile's fair market value over $13,200.

(B) If the automobile is first used under the lease in the third quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $110, and

(*2*) 10 percent of the excess of the automobile's fair market value over $13,200.

(C) If the automobile is first used under the lease in the second quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $100, and

(*2*) 9 percent of the excess of the automobile's fair market value over $13,200.

(D) If the automobile is first used under the lease in the first quarter of a taxable year, the dollar amount for each of the first three taxable years during which the automobile is leased is the sum of—

(*1*) $90, and

(*2*) 8 percent of the excess of the automobile's fair market value over $13,200.

(E) For the fourth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $18,000.

(F) For the fifth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $22,800.

(G) For the sixth taxable year during which the automobile is leased, the dollar amount is 6 percent of the excess of the automobile's fair market value over $27,600.

(5) *Seventh and subsequent taxable years.* (i) For any passenger automobile that has a fair market value less than or equal to $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is zero.

(ii) For any passenger automobile that has a fair market value greater than $32,400, the inclusion amount for the seventh and subsequent taxable years during which the automobile is leased is 6 percent of—

(A) The excess (if any) of the automobile's fair market value, over

(B) The sum of—

(*1*) $13,200 and

(*2*) $4,800 multiplied by the number of taxable years in excess of three years.

(6) *Additional inclusion amount when less than predominant use in a qualified business use.* (i) If a passenger automobile, which is leased after April 2, 1985, and before January 1, 1987, is not predominantly used in a qualified business use during a taxable year, the lessee must add to gross income in the first taxable year that the automobile is not so used (and only in that year) an inclusion amount determined under this paragraph (e)(6). This inclusion amount is in addition to the amount required to be included in gross income under paragraph (e) (2), (3), (4), and (5) of this section.

(ii) If the fair market value (as defined in paragraph (h)(2) of this section) of the automobile is greater than $11,250, the inclusion amount is determined by multiplying the average of the business/investment use (as defined in paragraph (h)(3) of this section) by the appropriate dollar amount from the table in paragraph (e)(6)(iii) of this section. If the fair market value of the automobile is $11,250 or less, the inclusion amount is the product of the fair market value of the automobile, the average business/investment use, and the applicable percentage from the table in paragraph (e)(6)(iv) of this section.

(iii) The dollar amount is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The dollar amount is:			
	Lease term (years)—			
	1	2	3	4 or more
The first taxable year of the lease term	$350	$700	$1,150	$1,500
The second taxable year of the lease term	....	150	700	1,200
The third taxable year of the lease term	....	....	250	750

(iv) The applicable percentage is determined under the following table:

If a passenger automobile is not predominantly used in a qualified business use during—	The applicable percentage:			
	Lease term (years)—			
	1	2	3	4 or more
The first taxable year of the lease term	3.0	6.0	10.2	13.2
The second taxable year of the lease term	....	1.25	6.2	10.4
The third taxable year of the lease term	....	....	2.25	6.5
The fourth taxable year of the lease term	....	....	....	1.7
The fifth taxable year of the lease term	....	....	....	0.5

(f) *Inclusions in income of lessees of listed property other than passenger automobiles*—(1) *In general*. If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This inclusion amount is determined under paragraph (f)(2) of this section for property leased after June 18, 1984, and before January 1, 1987. The inclusion amount is determined under §1.280F–7(b) for property leased after December 31, 1986.

(2) *Inclusion amount for property leased after June 18, 1984, and before January 1, 1987*. The inclusion amount for property leased after June 18, 1984, and before January 1, 1987, is the product of the following amounts:

(i) The fair market value (as defined in paragraph (h)(2) of this section) of the property,

(ii) The average business/investment use (as defined in paragraph (h)(3) of this section), and

(iii) The applicable percentage (as determined under paragraph (f)(3) of this section).

(3) *Applicable percentages*. The applicable percentages for 3-, 5-, and 10-year recovery property are determined according to the following tables:

(i) In the case of 3-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—					
	1	2	3	4	5	6 and later
For a lease term of:						
1 year	3.0	....	....	....	....	....
2 years	6.0	1.25	....	....	....	....
3 years	10.2	6.2	2.25	....	....	....
4 or more years	13.2	10.4	6.5	1.7	0.5	0

(ii) In the case of 5-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 percent or less, the applicable percentage for such taxable year is—											
	1	2	3	4	5	6	7	8	9	10	11	12
For a lease term of:												
1 year	2.7	....	....	....	....	....	....	....	....	....	....	....
2 years	5.3	1.2	....	....	....	....	....	....	....	....	....	....
3 years	9.9	6.1	1.6	....	....	....	....	....	....	....	....	....
4 years	14.4	11.1	7.3	2.3	....	....	....	....	....	....	....	....
5 years	18.4	15.7	12.4	8.2	3.0	....	....	....	....	....	....	....
6 or more years	21.8	19.6	16.7	13.5	9.6	5.25	4.4	3.6	2.8	1.8	1.0	0

(iii) In the case of 10-year recovery property:

Taxable year during lease term	For the first taxable year in which the business use percentage is 50 pct or less, the applicable percentage for such taxable year is—														
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
For a lease term of:															
1 year	2.5	....	....	....	....	....	....	....	....	....	....	....	....	....	....
2 years	5.1	.6	....	....	....	....	....	....	....	....	....	....	....	....	....
3 years	9.8	5.6	1.0	....	....	....	....	....	....	....	....	....	....	....	....
4 years	14.0	10.3	6.2	1.4	....	....	....	....	....	....	....	....	....	....	....
5 years	17.9	14.5	10.9	6.7	1.8	....	....	....	....	....	....	....	....	....	....
6 years	21.3	18.3	15.1	11.4	7.1	2.1	....	....	....	....	....	....	....	....	....
7 years	21.9	19.0	15.9	12.4	8.4	3.9	2.4	....	....	....	....	....	....	....	....
8 years	22.4	19.6	16.7	13.4	9.7	5.5	4.5	2.7	....	....	....	....	....	....	....
9 years	22.9	20.2	17.4	14.3	10.9	7.0	6.4	5.1	3.0	....	....	....	....	....	....
10 years	23.5	20.9	18.2	15.2	11.9	8.3	8.1	7.2	5.7	3.3	....	....	....	....	....
11 years	23.9	21.4	18.8	16.0	12.8	9.3	9.4	8.9	7.7	5.9	3.1	....	....	....	....
12 years	24.3	21.9	19.3	16.5	13.4	10.1	10.3	10.0	9.3	7.8	5.5	2.9	....	....	....
13 years	24.7	22.2	19.7	16.9	14.0	10.7	11.1	11.0	10.4	9.2	7.4	5.2	2.7	....	....
14 years	25.0	22.5	20.1	17.3	14.4	11.1	11.6	11.7	11.3	10.3	8.8	6.9	4.8	2.5	....
15 or more years	25.3	22.8	20.3	17.5	14.7	11.5	12.0	12.2	11.9	11.1	9.8	8.2	6.5	4.5	2.3

(g) *Special rules applicable to inclusions in income of lessees*. This paragraph (g) applies to the inclusions in gross income of lessees prescribed under paragraphs (d)(2), (e)(6), or (f) of this section, or prescribed under §1.280F–7(b).

(1) *Lease term commences within 9 months of the end of lessee's taxable year*. If:

(i) The lease term commences within 9 months before the close of the lessee's taxable year,

(ii) The property is not predominantly used in a qualified business use during that portion of the taxable year, and

(iii) The lease term continues into the lessee's subsequent taxable year, then the inclusion amount is added to gross income in the lessee's subsequent taxable year and the amount is determined by taking into account the average of the business/investment use for both taxable years and the applicable percentage for the taxable year in which the lease term begins (or, in the case of a passenger automobile with a fair market value greater than $16,500, the appropriate dollar amount for the taxable year in which the lease term begins).

(2) *Lease term less than one year*. If the lease term is less than one year, the amount which must be added to gross income is an amount that bears the same ratio to the inclusion amount determined before the application of this paragraph (g)(2) as the number of days in the lease term bears to 365.

(3) *Maximum inclusion amount*. The inclusion amount shall not exceed the sum of all deductible amounts in connection with the use of the listed property properly allocable to the lessee's taxable year in which the inclusion amount must be added to gross income.

(h) *Definitions*—(1) *Lease term*. In determining the term of any lease for purposes of this section, the rules of section 168(i)(3)(A) shall apply.

(2) *Fair market value*. For purposes of this section, the fair market value of listed property is such value on the first day of the lease term. If the capitalized cost of listed property is specified in the lease agreement, the lessee shall treat such amount as the fair market value of the property.

(3) *Average business/investment use*. For purposes of this section, the average business/investment use of any listed property is the average of the business/investment use for the first taxable year in which the business use percentage is 50 percent or less and all preceding taxable years in which such property is leased. See paragraph (g)(1) of this section for special rule when lease term commences within 9 months before the end of the lessee's taxable year.

(i) *Examples*. This section may be illustrated by the following examples.

Example 1. On January 1, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $55,000. The lease is to be for a period of four years. During taxable years 1985 and 1986, A uses the automobile exclusively in a trade or business. Under paragraph (d)(1) of this section, A must include in gross income in both 1985 and 1986, $2,887.50 (*i.e.*, ($55,000 − $16,500) × 7.5%).

Example 2. The facts are the same as in *Example 1,* and in addition, A uses the automobile only 45 percent in a trade or business during 1987. Under paragraph (d)(1) of this section for 1987, A must include in gross income $1,299.38 (*i.e.*, ($55,000 − $16,500) × 7.5% × 45%). In addition, under paragraph (d)(2) of this section, A must also include in gross income in 1987, $530.85 (*i.e.*, $650 × 81.67%, average business/investment use).

Example 3. On August 1, 1985, B, a calendar year taxpayer, leases and places in service an item of listed property which is 5-year recovery property, with a fair market value of $10,000. The lease is to be for a period of 5 years. B's qualified business use of the property is 40 percent in 1985, 100 percent in 1986, and 90 percent in 1987. Under paragraphs (f)(1) and (g)(1) of this section, before the application of paragraph (g)(3) of this section, B must include in gross income in 1986, $1,288.00 (*i.e.*, $10,000 × 70% × 18.4%, the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(iii) of this section).

Example 4. On October 1, 1985, C, a calendar year taxpayer, leases and places in service an item of listed property which is 3-year recovery property with a fair market value of $15,000. The lease term is 6 months (ending March 31, 1986) during which C uses the property 45 percent in a trade or business, the only business/investment use. Under paragraphs (f)(1) and (g) (1) and (2) of this section, before the application of paragraph (g)(3) of this section, C must include in gross income in 1986, $100.97 (*i.e.*, $15,000 × 45% × 3% × 182/365, the product of the fair market value, the average business use for both taxable years, and the applicable percentage for year one from the table in paragraph (f)(3)(i) of this section, prorated for the length of the lease term).

Example 5. On July 15, 1985, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $45,300. The lease is for a period of 5 years, during which A uses the automobile exclusively in a trade or business. Under paragraph (e) (2) and (3) of this section, for taxable years 1985 through 1989, A must include the following amounts in gross income:

Taxable year	Dollar amount	Proration	Business use (percent)	Inclusion
1985	$3,327	170/365	100	$1,550
1986	3,327	365/365	100	3,327
1987	3,327	365/365	100	3,327
1988	1,650	366/366	100	1,650
1989	1,362	365/365	100	1,362

Example 6. The facts are the same as in *Example 1,* except that A uses the automobile only 45 percent in a trade or business during 1987 through 1990. Under § 1.280F–5T(e)(6), A must include in gross income for taxable year 1987, the first taxable year in which the automobile is not used predominantly in a trade or business, an additional amount based on the average business/investment use for taxable years 1985 through 1987. For taxable years 1985 through 1989, A must include the following amounts in gross income:

Taxable year	Dollar amount	Proration	Business use (percent)	Inclusion
1985	$3,327	170/365	100	$1,550
1986	3,327	365/365	100	3,327
1987	3,327	365/365	45	1,497
	750	....	81.67	612
1988	1,650	366/366	45	743
1989	1,362	365/365	45	613

(98 Stat. 494, 26 U.S.C. 280F; 68A Stat. 917, 26 U.S.C. 7805)

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§ 1.280F–6 Special rules and definitions.

(a) *Deductions of employee*—(1) *In general.* Employee use of listed property shall not be treated as business/investment use (as defined in paragraph (d)(3) of this section) for purposes of determining the amount of any recovery deduction allowable (including any deduction under section 179) to the employee unless that use is for the convenience of the employer and required as a condition of employment.

(2) *''Convenience of the employer'' and ''condition of employment'' requirements*—(i) *In general.* The terms *convenience of the employer* and *condition of employment* generally have the same meaning for purposes of section 280F as they have for purposes of section 119 (relating to the exclusion from gross income for meals or lodging furnished for the convenience of the employer).

(ii) *''Condition of employment.''* In order to satisfy the ''condition of employment'' requirement, the use of the property must be required in order for the employee to perform the duties of his or her employment properly. Whether the use of the property is so required depends on all the facts and circumstances. Thus, the employer need not explicitly require the employee to use the property. Similarly, a mere statement by the employer that the use of the property is a condition of employment is not sufficient.

(iii) *''Convenience of employer''.* [Reserved]

(3) *Employee use.* For purposes of this section, the term *employee use* means any use in connection with the performance of services by the employee as an employee.

(4) *Examples.* The principles of this paragraph are illustrated in the following examples:

Example 1. A is employed as a courier with W, which provides local courier services. A owns and uses a motorcycle to deliver packages to downtown offices for W. W does not provide delivery vehicles and explicitly requires all of its couriers to own a car or motorcycle for use in their employment with the company. A's use of the motorcycle for delivery purposes is for the convenience of W and is required as a condition of employment.

Example 2. B is an inspector for X, a construction company with many construction sites in the local area. B is required to travel to the various construction sites on a regular basis; B uses her automobile to make these trips. Although X does not furnish B an automobile, X does not explicitly require B to use here own automobile. However, X reimburses B for any costs she incurs in traveling to the various job sites. B's use of here automobile in here employment is for the convenience of X and is required as a condition of employment.

Example 3. Assume the same facts as in *Example 2,* except that X makes an automobile available to B who chooses to use her own automobile and receive reimbursement. B's use of her own automobile is not for the convenience of X and is not required as a condition of employment.

Example 4. C is a pilot for Y, a small charter airline. Y requires its pilots to obtain x hours of flight time annually in addition to the number of hours of flight time spent with the airline. Pilots can usually obtain these hours by flying with a military reserve unit or by flying part-time with another airline. C owns his own airplane. C's use of his airplane to obtain the required flight hours is not for the convenience of the employer and is not required as a condition of employment.

Example 5. D is employed as an engineer with Z, an engineering contracting firm. D occasionally takes work home at night rather than working late in the office. D owns and uses a computer which is virtually identical to the one she uses at the office to complete her work at home. D's use of the computer is not for the convenience of here employer and is not required as a condition of employment.

(b) *Listed property*—(1) *In general.* Except as otherwise provided in paragraph (b)(5) of this section, the term *listed property* means:

(i) Any passenger automobile (as defined in paragraph (c) of this section),

(ii) Any other property used as a means of transportation (as defined in paragraph (b)(2) of this section),

(iii) Any property of a type generally used for purposes of entertainment, recreation, or amusement, and

(iv) Any computer or peripheral equipment (as defined in section 168(i)(2)(B)), and

(v) Any other property specified in paragraph (b)(4) of this section.

(2) *Means of transportation*—(i) *In general.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, property used as a *means of transportation* includes trucks, buses, trains, boats, airplanes, motorcycles, and any other vehicles for transporting persons or goods.

(ii) *Exception.* The term ''listed property'' does not include any vehicle that is a qualified nonpersonal use vehicle as defined in section 274(i) and §1.274–5(k).

(3) *Property used for entertainment, etc.*—(i) *In general.* Property of a type generally used for purposes of entertainment, recreation, or amusement includes property such as photographic, phonographic, communication, and video recording equipment.

(ii) *Exception.* The term *listed property* does not include any photographic, phonographic, communication, or video recording equipment of a taxpayer if the equipment is use either exclusively at the taxpayer's regular business establishment or in connection with the taxpayer's principal trade or business.

(iii) *Regular business establishment.* The regular business establishment of an employee is the regular business establishment of the employer of the employee. For purposes of this paragraph (b)(3), a portion of a dwelling unit is treated as a regular business establishment if the requirements of section 280A(c)(1) are met with respect to that portion.

(4) *Other property.* [Reserved]

(5) *Exception for computers.* The term *listed property* shall not include any computer (including peripheral equipment) used exclusively at a regular business establishment. For purposes of the preceding sentence, a portion of a dwelling unit shall be treated as a regular business establishment if (and only if) the requirements of section 280A(c)(1) are met with respect to that portion.

(c) *Passenger automobile*—(1) *In general.* Except as provided in paragraph (c)(3) of this section, the term *passenger automobile* means any 4-wheeled vehicle which is:

(i) Manufactured primarily for use on public streets, roads, and highways, and

(ii) Rated at 6,000 pounds gross vehicle weight or less.

(2) *Parts, etc. of automobile.* The term *passenger automobile* includes any part, component, or other item that is physically attached to the automobile or is traditionally included in the purchase price of an automobile. The term does not include repairs that are not capital expenditures within the meaning of section 263.

(3) *Exception for certain vehicles.* The term *passenger automobile* shall not include any:

(i) Ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

(ii) Vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, or

(iii) Truck or van that is a qualified nonpersonal use vehicle as defined under § 1.274–5T(k).

(d) *Business use percentage*—(1) *In general.* The term *business use percentage* means the percentage of the use of any listed property which is qualified business use as described in paragraph (d)(2) of this section.

(2) *Qualified business use*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, the term *qualified business use* means any use in a trade or business of the taxpayer. The term *qualified business use* does not include use for which a deduction is allowable under section 212. Whether the amount of qualified business use exceeds 50 percent is determinative of whether the investment tax credit and the accelerated percentages under section 168 are available for listed property (or must be recaptured). *See* § 1.280F–3T.

(ii) *Exception for certain use by 5-percent owners and related persons*—(A) *In general.* The term *qualified business use* shall not include:

(*1*) Leasing property to any 5-percent owner or related person,

(*2*) Use of property provided as compensation for the performance of services by a 5-percent owner or related person, or

(*3*) Use of property provided as compensation for the performance of services by any person not described in paragraph (d)(2)(ii)(A)(*2*) of this section unless an amount is properly reported by the taxpayer as income to such person and, where required, there was withholding under chapter 24.

Paragraph (d)(2)(ii)(A)(*1*) of this section shall apply only to the extent that the use of the listed property is by an individual who is a related party or a 5-percent owner with respect to the owner or lessee of the property.

(B) *Special rule for aircraft.* Paragraph (d)(2)(ii)(A) of this section shall not apply with respect to any aircraft if at least 25 percent of the total use of the aircraft during the taxable year consists of qualified business use not described in paragraph (d)(2)(ii)(A).

(C) *Definitions.* For purposes of this paragraph:

(*1*) *5-percent owner.* The term *5-percent owner* means any person who is a 5-percent owner with respect to the taxpayer (as defined in section 416 (i)(1)(B)(i)).

(*2*) *Related person.* The term *related person* means any person related to the taxpayer (within the meaning of section 267(b)).

(3) *Business/investment use*—(i) *In general.* The term *business/investment use* means the total business or investment use of listed property that may be taken into account for purposes of computing (without regard to section 280F(b)) the percentage of cost recovery deduction for a passenger automobile or other listed property for the taxable year. Whether the accelerated percentages under section 168 (as opposed to use of the straight line method of cost recovery) are available with respect to listed property or must be recaptured is determined, however, by reference to qualified business use (as defined in paragraph (d)(2) of this section) rather than by reference to business/investment use. Whether a particular use of property is a business or investment use shall generally be determined under the rules of section 162 or 212.

(ii) *Entertainment use.* The use of listed property for entertainment, recreation, or amusement purposes shall be treated as business use to the extent that expenses (other than interest and property tax expenses) attributable to that use are deductible after application of section 274.

(iii) *Employee use.* See paragraph (a) of this section for requirements to be satisfied for employee use of listed property to be considered business/investment use of the property.

(iv) *Use of taxpayer's automobile by another person.* Any use of the taxpayer's automobile by another person shall not be treated, for purposes of section 280F, as use in a trade or business under section 162 unless that use:

(A) Is directly connected with the business of the taxpayer,

(B) Is properly reported by the taxpayer as income to the other person and, where required, there was withholding under chapter 24, or

(C) Results in a payment of fair market rent.

For purposes of this paragraph (d)(4)(iv)(C), payment to the owner of the automobile in connection with such use is treated as the payment of rent.

(4) *Predominantly used in qualified business use*—(i) *Definition.* Property is predominantly used in a qualified business use for any taxable year if the business use percentage (as defined in paragraph (d)(1) of this section) is greater than 50 percent.

(ii) *Special rule for transfers at death.* Property does not cease to be used predominantly in a qualified business use by reason of a transfer at death.

(iii) *Other dispositions of property.* [Reserved]

(5) *Examples.* The following examples illustrate the principles set forth in this paragraph.

Example 1. E uses a home computer 50 percent of the time to manage her investments. The computer is listed property within the meaning of section 280F(d)(4). E also uses the computer 40 percent of the time in her part-time consumer research business. Because E's business use percentage for the computer does not exceed 50 percent, the computer is not predominantly used in a qualified business use for the taxable year. Her aggregate business/investment use for purposes of determining the percent of the total allowable straight line depreciation that she can claim is 90 percent.

Example 2. Assume that E in *Example 1* uses the computer 30 percent of the time to manage her investments and 60 percent of the time in her consumer research business. E's business use percentage exceeds 50 percent. Her aggregrate business/investment use for purposes of determining her allowable investment tax credit and cost recovery deductions is 90 percent.

Example 3. F is the proprietor of a plumbing contracting business. F's brother is employed with F's company. As part of his compensation, F's brother is allowed to use one of the company automobiles for personal use. The use of the company automobiles by F's brother is not a qualified business use because F and F's brother are related parties within the meaning of section 267(b).

Example 4. F, in *Example 3,* allows employees unrelated to him to use company automobiles as part of their compensation. F, however, does not include the value of these automobiles in the employees' gross income and F does not withhold with respect to the use of these automobiles. The use of the company automobiles by the employees in this case is not business/investment use.

Example 5. X Corporation owns several automobiles which its employees use for business purposes. The employees are also allowed to take the automobiles home at night. However, the fair market value of the use of the automobile for any personal purpose, *e.g.*, commuting to work, is reported by X as income to the employee and is withheld upon by X. The use of the automobile by the employee, even for personal purposes, is a qualified business use the respect to X.

(e) *Method of allocating use of property*—(1) *In general.* For purposes of section 280F, the taxpayer shall allocate the use of any listed property that is used for more than one purpose during the taxable year to the various uses in the manner prescribed in paragraph (e) (2) and (3) of this section.

(2) *Passenger automobiles and other means of transportation.* In the case of a passenger automobile or any other means of transportation, the taxpayer shall allocate the use of the property on the basis of mileage. Thus, the percentage of use in a trade or business for the year shall be determined by dividing the number of miles the vehicle is driven for purposes of that trade or business during the year by the total number of miles the vehicle is driven during the year for any purpose.

(3) *Other listed property.* In the case of other listed property, the taxpayer shall allocate the use of that property on the basis of the most appropriate unit of time the property is actually used (rather than merely being available for use). For example, the percentage of use of a computer in a trade or business for a taxable year is determined by dividing the number of hours the computer is used for business purposes during the year by the total number of hours the computer is used for any purpose during the year.

(f) *Effective date*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, this section applies to property placed in service by a taxpayer on or after July 7, 2003. For regulations applicable to property placed in service before July 7, 2003, see §1.280F–6T as in effect prior to July 7, 2003 (§1.280F–6T as contained in 26 CFR part 1, revised as of April 1, 2003).

(2) *Property placed in service before July 7, 2003.* The following rules apply to property that is described in paragraph (c)(3)(iii) of this section, was placed in service by the taxpayer before July 7, 2003, and was treated by the taxpayer as a passenger automobile under §1.280F–6T as in effect prior to July 7, 2003 (pre-effective date vehicle):

(i) Except as provided in paragraphs (f)(2)(ii), (iii), and (iv) of this section, a pre-effective date vehicle will be treated as a passenger automobile to which section 280F(a) applies.

(ii) A pre-effective date vehicle will be treated as property to which section 280F(a) does not apply if the taxpayer adopts that treatment in determining depreciation deductions on the taxpayer's original return for the year in which the vehicle is placed in service.

(iii) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iii), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on an amended Federal tax return in accordance with this paragraph (f)(2)(iii). This paragraph (f)(2)(iii) applies only if, on or before December 31, 2004, the taxpayer files, for all applicable taxable years, amended Federal tax returns (or qualified amended returns, if applicable (for further guidance, see Rev. Proc. 94–69 (1994–2 C.B. 804) and §601.601(d)(2)(ii)(*b*) of this chapter)) treating the vehicle as property to which section 280F(a) does not apply. The applicable taxable years for this purpose are the taxable year in which the vehicle was placed in service by the taxpayer (or, if the period of limitation for assessment under section 6501 has expired for such year or any subsequent year (a closed year), the first taxable year following the most recent closed year) and all subsequent taxable years in which the vehicle was treated on the taxpayer's return as property to which section 280F(a) applies. If the earliest applicable taxable year is not the year in which the vehicle was placed in service, the adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered over the remaining recovery period. If the remaining recovery period as of the beginning of the first applicable taxable year is less than 12 months, the entire adjusted depreciable basis of the property as of the beginning of the first applicable taxable year is recovered in that year.

(iv) A pre-effective date vehicle will be treated, to the extent provided in this paragraph (f)(2)(iv), as property to which section 280F(a) does not apply if the taxpayer adopts that treatment on Form 3115, Application for Change in Accounting Method, in accordance with this paragraph (f)(2)(iv). The taxpayer must follow the applicable administrative procedures issued under

§ 1.446–1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and § 601.601(d)(2)(ii)(*b*) of this chapter). If the taxpayer files a Form 3115 treating the vehicle as property to which section 280F(a) does not apply, the taxpayer will be permitted to treat the change as a change in method of accounting under section 446(e) of the Internal Revenue Code and to take into account the section 481 adjustment resulting from the method change. For purposes of Form 3115, the designated number for the automatic accounting method change authorized for this paragraph (f)(2)(iv) is 89.

[T.D. 7986, 49 FR 42713, Oct. 24, 1984, as amended by T.D. 8061, 50 FR 46041, Nov. 6, 1985; T.D. 9069, 68 FR 40130, July 7, 2003; T.D. 9133, 69 FR 35514, June 25, 2004; T.D. 9483, 75 FR 27937, May 19, 2010]

§ 1.280F–7 Property leased after December 31, 1986.

(a) *Inclusions in income of lessees of passenger automobiles leased after December 31, 1986*—(1) *In general.* If a taxpayer leases a passenger automobile after December 31, 1986, the taxpayer must include in gross income an inclusion amount determined under this paragraph (a), for each taxable year during which the taxpayer leases the automobile. This paragraph (a) applies only to passenger automobiles for which the taxpayer's lease term begins after December 31, 1986. See §§ 1.280F–5T(d) and 1.280F–5T(e) for rules on determining inclusion amounts for passenger automobiles for which the taxpayer's lease term begins before January 1, 1987. See § 1.280F–5T(h)(2) for the definition of fair market value.

(2) *Inclusion Amount.* For any passenger automobile leased after December 31, 1986, the inclusion amount for each taxable year during which the automobile is leased is determined as follows:

(i) For the appropriate range of fair market values in the applicable table, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding taxable year).

(ii) Prorate the dollar amount for the number of days of the lease term included in the taxable year.

(iii) Multiply the prorated dollar amount by the business/investment use (as defined in § 1.280F–6(d)(3)(i)) for the taxable year.

(iv) The following table is the applicable table in the case of a passenger automobile leased after December 31, 1986, and before January 1, 1989:

DOLLAR AMOUNTS FOR AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1987 OR 1988

Fair market value of automobile	Taxable year during lease					
	1st	2nd	3rd	4th	5 and later	
Over	Not over					
$12,800	$13,100	$2	$5	$7	$8	$9
13,100	13,400	6	14	20	24	28
13,400	13,700	10	23	34	41	47
13,700	14,000	15	32	47	57	65
14,000	14,300	19	41	61	73	84
14,300	14,600	23	50	74	89	103
14,600	14,900	27	59	88	105	122
14,900	15,200	31	68	101	122	140
15,200	15,500	35	77	115	138	159
15,500	15,800	40	87	128	154	178
15,800	16,100	44	96	142	170	196
16,100	16,400	48	105	155	186	215
16,400	16,700	52	114	169	203	234
16,700	17,000	56	123	182	219	253
17,000	17,500	62	135	200	240	277
17,500	18,000	69	150	223	267	309
18,000	18,500	76	166	246	294	340
18,500	19,000	83	181	268	321	371
19,000	19,500	90	196	291	348	402
19,500	20,000	97	211	313	375	433

DOLLAR AMOUNTS FOR AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 1987 OR 1988—Continued

Fair market value of automobile	Taxable year during lease					
	1st	2nd	3rd	4th	5 and later	
20,000	20,500	104	226	336	402	465
20,500	21,000	111	242	358	429	496
21,000	21,500	117	257	381	456	527
21,500	22,000	124	272	403	483	558
22,000	23,000	135	295	437	524	605
23,000	24,000	149	325	482	578	667
24,000	25,000	163	356	527	632	729
25,000	26,000	177	386	572	686	792
26,000	27,000	190	416	617	740	854
27,000	28,000	204	447	662	794	917
28,000	29,000	218	477	707	848	979
29,000	30,000	232	507	752	902	1,041
30,000	31,000	246	538	797	956	1,104
31,000	32,000	260	568	842	1,010	1,166
32,000	33,000	274	599	887	1,064	1,228
33,000	34,000	288	629	933	1,118	1,291
34,000	35,000	302	659	978	1,172	1,353
35,000	36,000	316	690	1,023	1,226	1,415
36,000	37,000	329	720	1,068	1,280	1,478
37,000	38,000	343	751	1,113	1,334	1,540
38,000	39,000	357	781	1,158	1,388	1,602
39,000	40,000	371	811	1,203	1,442	1,665
40,000	41,000	385	842	1,248	1,496	1,727
41,000	42,000	399	872	1,293	1,550	1,789
42,000	43,000	413	902	1,338	1,604	1,852
43,000	44,000	427	933	1,383	1,658	1,914
44,000	45,000	441	963	1,428	1,712	1,976
45,000	46,000	455	994	1,473	1,766	2,039
46,000	47,000	468	1,024	1,518	1,820	2,101
47,000	48,000	482	1,054	1,563	1,874	2,164
48,000	49,000	496	1,085	1,608	1,928	2,226
49,000	50,000	510	1,115	1,653	1,982	2,288
50,000	51,000	524	1,146	1,698	2,036	2,351
51,000	52,000	538	1,176	1,743	2,090	2,413
52,000	53,000	552	1,206	1,788	2,144	2,475
53,000	54,000	566	1,237	1,834	2,198	2,538
54,000	55,000	580	1,267	1,879	2,252	2,600
55,000	56,000	594	1,297	1,924	2,306	2,662
56,000	57,000	607	1,328	1,969	2,360	2,725
57,000	58,000	621	1,358	2,014	2,414	2,787
58,000	59,000	635	1,389	2,059	2,468	2,849
59,000	60,000	649	1,419	2,104	2,522	2,912
60,000	62,000	670	1,465	2,171	2,603	3,005
62,000	64,000	698	1,525	2,262	2,711	3,130
64,000	66,000	726	1,586	2,352	2,819	3,255
66,000	68,000	753	1,647	2,442	2,927	3,379
68,000	70,000	781	1,708	2,532	3,035	3,504
70,000	72,000	809	1,768	2,622	3,143	3,629
72,000	74,000	837	1,829	2,712	3,251	3,753
74,000	76,000	865	1,890	2,802	3,359	3,878
76,000	78,000	892	1,951	2,892	3,468	4,003
78,000	80,000	920	2,012	2,982	3,576	4,128
80,000	85,000	969	2,118	3,140	3,765	4,346
85,000	90,000	1,038	2,270	3,365	4,035	4,658
90,000	95,000	1,108	2,422	3,590	4,305	4,969
95,000	100,000	1,177	2,574	3,816	4,575	5,281
100,000	110,000	1,282	2,802	4,154	4,980	5,749
110,000	120,000	1,421	3,105	4,604	5,520	6,372
120,000	130,000	1,560	3,409	5,055	6,060	6,996
130,000	140,000	1,699	3,713	5,505	6,600	7,619
140,000	150,000	1,838	4,017	5,956	7,140	8,243
150,000	160,000	1,977	4,321	6,406	7,680	8,866
160,000	170,000	2,116	4,625	6,857	8,221	9,490
170,000	180,000	2,255	4,929	7,307	8,761	10,113
180,000	190,000	2,394	5,232	7,758	9,301	10,737
190,000	200,000	2,533	5,536	8,208	9,841	11,360

(v) The applicable table in the case of a passenger automobile first leased after December 31, 1988, will be contained in a revenue ruling or revenue procedure published in the Internal Revenue Bulletin.

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

Example. On April 1, 1987, A, a calendar year taxpayer, leases and places in service a passenger automobile with a fair market value of $31,500. The lease is to be for a period of three years. During taxable years 1987 and 1988, A uses the automobile exclusively in a trade or business. During 1989 and 1990, A's business/investment use is 45 percent. The appropriate dollar amounts from the table in paragraph (a)(2)(iv) of this section are $260 for 1987 (first taxable year during the lease), $568 for 1988 (second taxable year during the lease), $842 for 1989 (third taxable year during the lease), and $842 for 1990. Since 1990 is the last taxable year during the lease, the dollar amount for the preceding year (the third year) is used, rather than the dollar amount for the fourth year. For taxable years 1987 through 1990, A's inclusion amounts are determined as follows:

Tax year	Dollar amount	Proration	Business use (percent)	Inclusion amount
1987	$260	275/365	100	$196
1988	568	366/366	100	568
1989	842	365/365	45	379
1990	842	90/365	45	93

(b) *Inclusions in income of lessees of listed property (other than passenger automobiles) leased after December 31, 1986*—(1) *In general.* If listed property other than a passenger automobile is not used predominantly in a qualified business use in any taxable year in which such property is leased, the lessee must add an inclusion amount to gross income in the first taxable year in which such property is not so predominantly used (and only in that year). This year is the first taxable year in which the business use percentage (as defined in § 1.280F–6(d)(1)) of the property is 50 percent or less. This inclusion amount is determined under this paragraph (b) for property for which the taxpayer's lease term begins after December 31, 1986 (and under § 1.280F–5T(f) for property for which the taxpayer's lease term begins before January 1, 1987). See also § 1.280F–5T(g).

(2) *Inclusion amount.* The inclusion amount for any listed property (other than a passenger automobile) leased after December 31, 1986, is the sum of the amounts determined under subdivisions (i) and (ii) of this subparagraph (2).

(i) The amount determined under this subdivision (i) is the product of the following amounts:

(A) The fair market value (as defined in § 1.280F–5T(h)(2)) of the property,

(B) The business/investment use (as defined in § 1.280F–6(d)(3)(i)) for the first taxable year in which the business use percentage (as defined in § 1.280F–6(d)(1)) is 50 percent or less, and

(C) The applicable percentage from the following table:

Type of property	First taxable year during lease in which business use percentage is 50% or less											
	1	2	3	4	5	6	7	8	9	10	11	12 and Later
Property with a recovery period of less than 7 years under the alternative depreciation system (such as computers, trucks and airplanes)	2.1	−7.2	−19.8	−20.1	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4	−12.4
Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)	3.9	−3.8	−17.7	−25.1	−27.8	−27.2	−27.1	−27.6	−23.7	−14.7	−14.7	−14.7
Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)	6.6	−1.6	−16.9	−25.6	−29.9	−31.1	−32.8	−35.1	−33.3	−26.7	−19.7	−12.2

(ii) The amount determined under this subdivision (ii) is the product of the following amounts:

(A) The fair market value of the property,

(B) The average of the business/investment use for all taxable years (in which such property is leased) that precede the first taxable year in which the business use percentage is 50 percent or less, and

(C) The applicable percentage from the following table:

Type of property	First taxable year during lease in which business use percentage is 50% or less											
	1	2	3	4	5	6	7	8	9	10	11	12 and Later
Property with a recovery period of less than 7 years under the alternative depreciation system (Such as computers, trucks and airplanes)	0.0	10.0	22.0	21.2	12.7	12.7	12.7	12.7	12.7	12.7	12.7	12.7
Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)	0.0	9.3	23.8	31.3	33.8	32.7	31.6	30.5	25.0	15.0	15.0	15.0
Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)	0.0	10.1	26.3	35.4	39.6	40.2	40.8	41.4	37.5	29.2	20.8	12.5

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

Example. On February 1, 1987, B, a calendar year taxpayer, leases and places in service a computer with a fair market value of $3,000. The lease is to be for a period of two years. B's qualified business use of the property, which is the only business/investment use, is 80 percent in taxable year 1987, 40 percent in taxable year 1988, and 35 percent in taxable year 1989. B must add an inclusion amount to gross income for taxable year 1988, the first taxable year in which B does not use the computer predominantly for business (*i.e.*, the first taxable year in which B's business use percentage is 50 percent or less). Since 1988 is the second taxable year during the lease, and since the computer has a 5-year recovery period under the General and Alternative Depreciation Systems, the applicable percentage from the table in subdivision (i) of paragraph (b)(2) is −7.2%, and the applicable percentage from the table in subdivision (ii) is 10%. B's inclusion amount is $154, which is the sum of the amounts determined under subdivisions (i) and (ii) of subparagraph (b)(2) of this paragraph. The amount determined under subdivision (i) is −$86 [$3,000 × 40% × (−7.2%)], and the amount determined under subdivision (ii) is $240 [$3,000 × 80% × 10%].

[T.D. 8218, 53 FR 29881, Aug. 9, 1988; 53 FR 32821, Aug. 26, 1988, as amended by T.D. 8298, 55 FR 13370, Apr. 12, 1990; Redesignated and amended at T.D. 8473, 58 FR 19060, Apr. 12, 1993; T.D. 9133, 69 FR 35515, June 25, 2004; T.D. 9483, 75 FR 27937, May 19, 2010]

§ 1.280G–1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Pub. L. No. 98–369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Pub. L. No. 99–514; 100 Stat. 2807), section 1018(d)(6)–(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100–647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Pub. L. No. 104–188; 110 Stat. 1755). The following is a table of subjects covered in this section:

Overview

Exempt Payments

Overview

Q–1: What is the effect of Internal Revenue Code section 280G?

A–1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

(b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q–2: What is a parachute payment for purposes of section 280G?

A–2: (a) The term *parachute payment* means any payment (other than an exempt payment described in Q/A–5) that—

(1) Is in the nature of compensation;

(2) Is made or is to be made to (or for the benefit of) a disqualified individual;

(3) Is contingent on a change—

(i) In the ownership of a corporation;

(ii) In the effective control of a corporation; or

(iii) In the ownership of a substantial portion of the assets of a corporation; and

(4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A–2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

(b) Hereinafter, a change referred to in paragraph (a)(3) of this A–2 is generally referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), *see* Q/A–11 through Q/A–14; paragraph (a)(2), Q/A–15 through Q/A–21; paragraph (a)(3), Q/A–22 through Q/A–29; and paragraph (a)(4), Q/A–30 through Q/A–36.

(c) The term *parachute payment* also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. *See* Q/A–37 for the definition and treatment of securities violation parachute payments.

Q–3: What is an excess parachute payment for purposes of section 280G?

A–3: The term *excess parachute payment* means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, *see* Q/A–37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, *see* Q/A–38 through Q/A–44.

Q–4: What is the effective date of section 280G and this section?

A–4: In general, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment that is contingent on a change in ownership or control and the change in ownership or control occurs on or after January 1, 2004. For a discussion of the application of the effective date, *see* Q/A–47 and Q/A–48.

Exempt Payments

Q–5: Are some types of payments exempt from the definition of the term *parachute payment?*

A–5: (a) Yes, the following five types of payments are exempt from the definition of *parachute payment—*

(1) Payments with respect to a small business corporation (described in Q/A–6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A–6 of this section);

(3) Payments to or from a qualified plan (described in Q/A–8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as *tax-exempt organizations* (described in Q/A–6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A–9 of this section).

(b) Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section.

Q–6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A–5 of this section are exempt from the definition of *parachute payment?*

A–6: (a) The term *parachute payment* does not include—

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a corporation under section 1361 in effect on the date of the change in ownership or control;

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A–6) if—

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A–7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A–5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A–6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A–6 are not met with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and any ownership interest in such entity is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. If a corporation is a member of an affiliated group (which group is treated as one corporation under A–46 of this section), the requirements of paragraph (a)(2)(i) of this A–6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A–6, the term *stock* does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A–6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A–6, the term *established securities market* means an established securities market as defined in §1.897–1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A–6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in *Example 1,* except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A–6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A–7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A–2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of *parachute payments* under this A–6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A–5(a)(4), would constitute a *parachute payment.* However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a *tax-exempt organization* both immediately before and immediately after the change in ownership or control, as required by this A–6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of parachute payment under this A–6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a *tax-exempt organization* because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a *parachute payment,* such payment is not exempt from the definition of the term *parachute payment* for purposes of this A–6.

Q–7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A–6 of this section met?

A–7: (a) *General rule.* The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A–6 of this section are met with respect to any payment if—

(1) Such payment is approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A–7) immediately before the change in ownership or control; and

(2) Before the vote, there was adequate disclosure to all persons entitled to vote (as described in this A–7) of all material facts concerning all material payments which (but for Q/A–6 of this section) would be parachute payments with respect to a disqualified individual.

(b) *Voting requirements*—(1) *General rule.* The vote described in paragraph (a)(1) of this A–7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. Except as otherwise provided in this A–7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A–7. For purposes of this A–7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A–6 of this section.

(2) *Special rule*. A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record as of any day within the six-month period immediately prior to and ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A–7 are met.

(3) *Entity shareholder*. (i) Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. See paragraph (b)(4) of this A–7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met.

(ii) However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder entitled to vote. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation undergoing a change in ownership or control. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this (b)(3)(ii), stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity shareholder. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) *Disqualified individuals and attribution of stock ownership*. In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A–7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A–7 if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A–7 are not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if the person authorized to vote the stock of an entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements described in this A–7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent vote has been obtained.

(c) *Adequate disclosure*. To be adequate disclosure for purposes of paragraph (a)(2) of this A–7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure is made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A–7. For each disqualified individual, material facts that must be disclosed include, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A–7 are not met, and a brief description of each payment (*e.g.*, accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) *Corporation without shareholders.* If a corporation does not have shareholders, the exemption described in Q/A–6(a)(2) of this section and the shareholder approval requirements described in this A–7 do not apply. Solely for purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e) *Examples.* The following examples illustrate the application of this A–7:

Example 1. Corporation S has two shareholders—Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A–7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to certain officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock entitled to vote of Corporation P and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 2. (i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the sale, the Corporation X shareholders are asked to vote either ''yes'' on the sale and ''yes'' to paying parachute payments to A, a disqualified individual with respect to Corporation A, or ''no'' on the sale and ''no'' to paying parachute payments to A.

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A–7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of *parachute payment* pursuant to Q/A–6 of this section.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A–7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments cannot be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A–7 are met, the payments are exempt from the definition of *parachute payment* pursuant to Q/A–6 of this section.

Example 3. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. The general partner is not a disqualified individual. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A–7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A–7 are complied with, the shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A–7 are not met. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder approval requirements of paragraph (a)(1) of this A–7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not entitled to vote.

Example 5. Assume the same facts as in *Example 4,* except that after adequate disclosure of all material facts (within the meaning of paragraph (a)(2) of this A–7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in *Example 4* except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A–7) regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Both shareholders approve the payments. Assume further that no adequate disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A–7. Notwithstanding that 80 percent of the shareholders entitled to vote approve the payments, because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A–7 are not met, and the payments are not exempt from the definition of *parachute payment* pursuant to Q/A–6.

Example 7. Corporation C has three shareholders—Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who are entitled to vote referred to in paragraph (a)(1) of this A–7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A–7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). Each individual has a base amount of $100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of $400,000 is payable to X; $600,000 is payable to Y; and $1,000,000 is payable to Z. Corporation E provides each Corporation E shareholder entitled to vote (as determined under this A–7) with a ballot listing and describing the payments of $400,000 to X; $600,000 to Y; and $1,000,000 to Z and the triggering event that generated the payments. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a ''yes'' and ''no'' box) of each total payment to be made to each individual and states that if the payment is not approved the payment will not be made. Adequate disclosure, within the meaning of this A–7 is made to each shareholder entitled to vote under this A–7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A–7 approve each payment to each individual. The shareholder approval requirements of this A–7 are met, and the payments are exempt from the definition of *parachute* payment pursuant to A–6 of this section.

Example 9. Assume the same facts as in Example 8 except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that $2,000,000 in payments will be made to X, Y, and Z and requests approval of the $2,000,000 payments. Assuming the triggering event and amount of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A–7, the shareholder approval requirements of paragraph (a)(1) of this A–7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Example 10. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is $205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of $500,000 immediately vest, $200,000 of which is contingent on the change, and B will receive a $200,000 bonus payment and a $400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote as described in this A–7. The ballot contains adequate disclosure of all material facts and lists the following payments to be made to B: The contingent payment of $200,000 attributable to options, a $200,000 bonus payment, and a $400,000 severance payment. The ballot requests shareholder approval of the $200,000 bonus payment to B and states that whether or not the $200,000 bonus payment is approved, B will receive $200,000 attributable to options and a $400,000 severance payment. More than 75 percent of the shareholders entitled to vote as described by this A–7 approve the $200,000 bonus payment to B. The shareholder approval requirements of this A–7 are met, and the $200,000 payment is exempt from the definition of *parachute payment* pursuant to A–6 of this section.

Q–8: Which payments under a qualified plan are exempt from the definition of *parachute payment?*

A–8: The term *parachute payment* does not include any payment to or from—

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A simplified employee pension (as defined in section 408(k)); or

(d) A simple retirement account (as defined in section 408(p)).

Q–9: Which payments of reasonable compensation are exempt from the definition of *parachute payment?*

A–9: Except in the case of securities violation *parachute payment*s, the term parachute payment does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments. See Q/A–40 through Q/A–44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q–10: Who may be the payor of parachute payments?

A–10: Parachute payments within the meaning of Q/A–2 of this section may be paid, directly or indirectly, by—

(i) The corporation referred to in paragraph (a)(3) of Q/A–2 of this section;

(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q–11: What types of payments are in the nature of compensation?

A–11: (a) *General rule.* For purposes of this section, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits, and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, (including the value of accelerated vesting under Q/A–24(c), or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) *When payment is considered to be made.* Except as otherwise provided in A–11 through Q/A–13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) *Prepayment rule.* Notwithstanding the general rule described in paragraph (b) of this A–11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; *see* Q/A–32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. However, a disqualified individual may not apply this paragraph (c) of this A–11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and §31.3121(v)(2)–1(e)(4) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(d) *Transfers of property*. Transfers of property are treated as payments for purposes of this A–11. See Q/A–12 of this section for rules on determining when such payments are considered made and the amount of such payments. *See* Q/A–13 of this section for special rules on transfers of stock options.

(e) The following example illustrates the principles of this A–11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of $100,000 and is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the $200,000 payment is made to D at the time of the change in ownership or control. The $400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the $400,000 payment. Using discount rate determined under Q/A–32, Corporation X and D determine that the present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) × $100,000) and $60,000 (($300,000/$500,000 × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that of the second excess parachute payment is $340,000 ($400,000 − $60,000). The excise tax on the $400,000 payment is $68,000 ($340,000 × 20 percent). Assume the present value (calculated in accordance with paragraph (c) of this A–11) of $68,000 is $50,000. To prepay the excise tax due on the $400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the $50,000, in addition to the $32,000 withholding required with respect to the $200,000 payment.

Q–12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A–12: (a) Except as provided in this A–12 and Q/A–13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in §1.83–3(a)) to the disqualified individual and becomes substantially vested (as defined in §1.83–3(b) and (j)) in such individual. The amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in §1.83–3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A–12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, for purposes of this section, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) *See* Q/A–13 of this section for rules on applying this A–12 to transfers of stock options.

(d) The following example illustrates the principles of this A–12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of §1.83–3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of §1.83–3(c)) and are nontransferable (within the meaning of §1.83–3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of §1.83–3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 × $250). *See* Q/A–38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q–13: How are transfers of statutory and nonstatutory stock options treated?

A–13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in §1.83–7(b)). For purposes of this A–13, *vested* means substantially vested within the meaning of §1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture within the meaning of section 83(c). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: The difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without regard to whether such option has an ascertainable fair market value. For purposes of this A–13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under §601.601(d)(2) of this Chapter.

(b) Any money or other property transferred to the disqualified individual on the exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A–13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A–11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A–13 treated as an excess parachute payment.

Q–14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A–14: Yes, to the extent not otherwise taken into account under Q/A–12 and Q/A–13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q–15: Who is a disqualified individual?

A–15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period* (as defined in Q/A–20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation—

(1) A shareholder (but *see* Q/A–17 of this section);

(2) An officer (*see* Q/A–18 of this section); or

(3) A highly-compensated individual (*see* Q/A–19 of this section).

(b) For purposes of this A–15, a director is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period*, the director is, with respect to the corporation, a shareholder (*see* Q/A–17 of this section), an officer (*see* Q/A–18 of this section), or a highly-compensated individual (*see* Q/A–19 of this section).

(c) For purposes of this A–15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

Q–16: Is a personal service corporation treated as an individual?

A–16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a noncorporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A–16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of highly-compensated individuals of Corporation M as determined under A–19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q–17: Are all shareholders of a corporation considered shareholders for purposes of paragraphs (a)(1) and (b) of Q/A–15 of this section?

A–17: (a) No. Only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer (*see* Q/A–18) or highly-compensated individual (see Q/A–19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A–17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§ 1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A–17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrates the principles of this A–17:

Example 1. E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period. E does not own, and is not considered to own under section 318, any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. Under paragraph (b) of this A–17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q&A–15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in *Example* 1, except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. Under paragraph (b) of this A–17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in *Example 1* except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. Under paragraph (b) of this A–17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to own Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of Q/A–15 of this section with respect to Corporation A.

Q–18: Who is an officer?

A–18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. Generally, the term officer means an administrative executive who is in regular and continued service. The term officer implies continuity of service and excludes those employed for a special and single transaction.

(b) An individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q/A–46 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A–21 of this section) paid during the disqualified individual determination period.

(d) In determining the total number of employees of a corporation for purposes of this A–18, employees are not counted if they normally work less than 17½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be an officer.

Q–19: Who is a highly-compensated individual?

A–19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A–21 of this section) earned during the disqualified individual determination period (as defined in Q/A–20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A–20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

(c) The total number of employees of a corporation for purposes of this A–19 is determined in accordance with Q/A–18(d) of this section. However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q–20: What is the disqualified individual determination period?

A–20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q–21: How is *compensation* defined for purposes of determining who is a disqualified individual?

A–21: (a) For purposes of determining who is a disqualified individual, the term *compensation* means the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity, and amounts credited under a nonqualified deferred compensation plan.

(b) For purposes of this A–21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term *related entity* includes—

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or businesses (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A–18 and Q/A–19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q–22: When is a payment contingent on a change in ownership or control?

A–22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. (But *see* Q/A–23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A–22, *vested* means the payment is substantially vested within the meaning of §1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture as defined by section 83(c).

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if—

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A–22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A–27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A–22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of the change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change in ownership or control because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated with and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A–22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. *See* Q/A–24 of this section regarding the portion of a payment that is so treated. *See also* Q/A–8 of this section regarding the exemption for certain payments under qualified plans and Q/A–40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A–22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A–22. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership or control of the corporation occurs. Six months after the change in ownership or control, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership or control, the termination of C's employment is presumed to be materially related to the change in ownership or control under paragraph (b)(3) of this A–22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership or control under paragraph (b) of this A–22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership or control of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A–37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership or control of the corporation occurs and within one year after the date of the change of ownership or control, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change in ownership or control, the payment will not be treated as contingent on a change in ownership or control.

Q–23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A–23: (a) No. Payments are not treated as contingent on a change in ownership or control if they are made (or are to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (*See* Q/A–9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a payment that would be a parachute payment if made under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. To the extent payments under the agreement have the same value as the payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A–23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in *Example 1,* except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A–22 of this section. However, see Q/A–9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in *Example 1,* except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to payments under the pre-change agreement that would be parachute payments if made, in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A–23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q–24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A–24: (a)(1) *General rule.* Yes. If the payment is a transfer of property, the amount of the payment is determined under Q/A–12 or Q/A–13 of this section. For all other payments, the amount of the payment is determined under Q/A–11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A–24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A–24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A–24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A–25 of this section. For purposes of this A–24, vested has the same meaning as provided in Q/A–22(a).

(2) *Reduction by reasonable compensation.* The amount of a payment under paragraph (a)(1) of this A–24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services rendered by the disqualified individual on or after the date of the change of control. *See* Q/A–9 and Q/A–38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A–24 may not be reduced by reasonable compensation.

(b) *Vested payments.* This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such a case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, *see* paragraph (e) of this A–24, Q/A–32, and Q/A–33 of this section.

(c)(1) *Nonvested payments.* This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that—

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2) The portion of the payment subject to paragraph (c) of this A–24 that is treated as contingent on the change in ownership or control is the amount described in paragraph (b) of this A–24, plus an amount, as determined in paragraph (c)(4) of this A–24, to reflect the lapse of the obligation to continue to perform services. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3) For purposes of this paragraph (c) of this A–24, the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2) of this A–24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested.

(d) *Application of this A–24 to certain payments*—(1) *Benefits under a nonqualified deferred compensation plan.* In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A–24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A–24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A–24 and the rules in Q/A–11 of this section.

(2) *Employment agreements.* The general rule of paragraph (a) of this A–24 (and not the rules in paragraphs (b) or (c)) applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A–24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. *See* Q/A–42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) *Vesting due to an event other than services.* Neither paragraph (b) nor (c) of this A–24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A–24. However, *see* Q/A–39 of this section for rules relating to the reduction of the excess parachute payment by the portion of

the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e) *Present value.* For purposes of this A–24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) *Examples.* The following examples illustrate the principles of this A–24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of $500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in $500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A–24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration.

(iii) Assume the same facts as in paragraph (i) of this *Example 1*, except that E's account balance of $500,000 is not vested. Instead, assume that E will vest in E's account balance of $500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv) Assume the same facts as in paragraph (i) of this *Example 1*, except that in addition to the pay out of the vested account balance of $500,000 on the change in ownership or control, an additional $70,000 will be credited to E's account and included in the payment to E. Because the $500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A–24 applies to the $500,000 payment. Because the $70,000 is not vested, without regard to the change, and is not attributable to the performance of services prior to the change, the entire $70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A–24.

(v) Assume the same facts as in paragraph (i) of this *Example 1*, except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit is contingent on the change in ownership or control under paragraph (a) of this A–24.

Example 2. As a result of a change in the effective control of a corporation D, a disqualified individual with respect to the corporation, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of $500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment

($500,000) is made on that date to F. Under these facts, the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment, as determined under paragraph (c) of this A–24 is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e.*, $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.*, $406,838, the present value on January 15, 2009, of a $500,000 payment on January 15, 2011), plus $115,000 (1 percent × 23 months × $500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is $208,162, the sum of $93,162 ($500,000 − $406,838) + $115,000). This result does not change if F actually remains employed until the end of the 5-year period.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*, except that the retention bonus will vest on the change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment is treated as contingent on the change in ownership or control as determined under paragraph (c) of this A–24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A–27, which is $0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is $93,573 (1 percent × 23 months × $406,838 (the present value of a $500,000 payment).

Example 4. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of §1.83–3(b) and (j)) during that period. On January 15, 2009, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment, as determined under paragraph (c) of this A–24, is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be $500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a $500,000 payment to be made on January 15, 2011, is $406,838. Thus, the portion of the payment treated as contingent on the change is $208,162, the sum of $93,162 ($500,000 − $406,838), plus $115,000 (1 percent × 23 months × $500,000), the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A–13, is $600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $600,000 payment to be made on January 15, 2009, is $549,964. Thus, the portion of the payment treated as contingent on the change is $116,036, the sum of $50,036 ($600,000 − $549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is $66,000 (1 percent × 11 months × $600,000).

Example 6. (i) Assume the same facts as in *Example 5,* except that the options become vested periodically (absent a change in ownership or control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership or control and the options to purchase the remaining 10,000 shares vest as a result of the change in ownership or control.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment as determined under paragraph (c) of this A–24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control is the amount by which the accelerated payment on January 16, 2008 ($200,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change in ownership or control, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $200,000 payment to be made on January 15, 2009, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $38,671.62, the sum of $16,671.62 ($200,000 − $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is $22,000 (1 percent × 11 months × $200,000).

Example 7. Assume the same facts as in *Example 5,* except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full amount of the payment, $600,000, is treated as contingent on the change in ownership or control under paragraph (a) of this A–24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A–24 do not apply. See Q/A–39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2005, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of $200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2006, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of $200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (*i.e.,* amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A–24 applies to the payment and not the rules of paragraphs (b) and (c) of this A–24. See Q/A–42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q–25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A–25: Yes, for purposes of this section, any payment is presumed to be contingent on such a change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to—

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control.

In the case of an amendment described in paragraph (b) of this A–25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q–26: How may the presumption described in Q/A–25 of this section be rebutted?

A–26: (a) To rebut the presumption described in Q/A–25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

(b) In the case of an agreement described in Q/A–25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control—

(1) A *nondiscriminatory employee plan or program as defined* in paragraph (c) of this A–26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term *nondiscriminatory employee plan or program* means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under § 601.601(d)(2). Payments under certain other plans are exempt from the definition of *parachute payment* under Q/A–8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change in ownership or control and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A–25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 2. Assume the same facts as in *Example 1*, except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership or control would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or control even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A–25 of this section with respect to all of the payments under the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A–22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership or control of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. If clear and convincing evidence does not rebut the presumption described in A–25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership or control, the payment is presumed contingent on the change under A–25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/A–22 of this section.

Change in Ownership or Control

Q–27: When does a change in the ownership of a corporation occur?

A–27: (a) For purposes of this section, a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A–27), acquires ownership of stock of the corporation that, together with stock held by such person or group, has more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A–28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section. This A–27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (*See* Q/A–29 for rules regarding the transfer of assets of a corporation).

(b) For purposes of paragraph (a) of this A–27, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A–27 (and Q/A–28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83–3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A–27.

(d) The following examples illustrate the principles of this A–27:

Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A–29, *Example 3,* regarding whether there is a change in ownership or control of P.

Example 4. Assume the same facts as in *Example 3,* except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A–29, *Example 3,* regarding whether there is a change in ownership or control of P.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in *Example 5*, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q–28: When does a change in the effective control of a corporation occur?

A–28: (a) Notwithstanding that a corporation has not undergone a change in ownership under Q/A–27, for purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either—

(1) Any one person, or more than one person acting as a group (as determined under paragraph (e) of this A–28), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b) The presumption of paragraph (a) of this A–28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A–28, a change in the effective control of a corporation is presumed not to have occurred.

(c) In no event does a change in effective control under this A–28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A–27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A–29 of this section, O does not have a change in effective control under Q/A–28.

(d) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A–28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A–27 of this section).

(e) For purposes of this A–28, persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, *see* Q/A–27(c).

(g) The following examples illustrate the principles of this A–28:

Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A–28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A–27 of this section) because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q–29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A–29: (a) For purposes of this section, a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as determined in paragraph (c) of this A–29), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, *gross fair market value* means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. This A–29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A–29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A–46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b) (1) There is no change in ownership or control under this A–29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (b). A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to—

(i) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(ii) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(iii) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(iv) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(1)(iii) of this A–29.

(2) For purposes of paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A–29, persons will not be considered to be acting as a group merely because they happen to purchase assets of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) For purposes of determining stock ownership, see Q/A–27(c).

(e) The following examples illustrate the principles of this A–29:

Example 1. Corporation M acquires assets having a gross fair market value of $500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was $3 million. Since the value of the assets acquired by Corporation M is less than one-third of the total gross fair market value of Corporation N's total assets immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2. Assume the same facts as in *Example 1.* Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of $700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of $1.2 million during the 12-month period ending on November 1, 2006. Since $1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions ($3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

Example 3. (i) All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A–27) of Corporation O occurs.

(ii) The result in paragraph (i) would be the same if immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P. See Q/A–27, *Example 4,* regarding whether there is a change in ownership or control of O.

Example 4. Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is $210 million. The fair market value of S, determined without regard to its liabilities, is $80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

Three-Times-Base-Amount Test for Parachute Payments

Q–30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A–30: (a) No. To determine whether such payments are parachute payments, they must be tested against the individual's *base amount* (as defined in Q/A–34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payment is a parachute payment. See Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A–37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A–30:

Example 1. A is a disqualified individual with respect to Corporation M. A's base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M totaling $400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of $100,000 (3 × x$100,000 = $300,000).

Example 2. Assume the same facts as in *Example 1,* except that the payments contingent on the change in the ownership or control of Corporation M total $290,000. Because the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q–31: As of what date is the present value of a payment determined?

A–31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)(1) For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A–32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A–31 and for applying the 3-times-base-amount test under Q/A–30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A–30 and this A–31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q–32: What discount rate is to be used to determine present value?

A–32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). See Q/A–24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q–33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A–33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A–30 of this section, or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A–2 of this section, at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose.

(b) If the estimate made under paragraph (a) of this A–33 is later determined to be incorrect, the 3-times-base-amount test described in Q/A–30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A–31 of this section, using the discount rate described in A–32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A–33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A–33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) To the extent provided in published guidance of general applicability under § 601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A–13 of this section is permitted to be made, with the valuation subsequently re-determined, and the 3-times-base-amount test reapplied.

(d) The following examples illustrate the principles of this A–33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of $250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A–31 and Q/A–32 of this section.

Example 2. Assume the same facts as in *Example 1*, except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of $200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of $600,000 and a bonus payment of $400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of $500,000. A change in ownership or control of Corporation P occurs, and B receives the $600,000 and $400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the $500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the $500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the $500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the $500,000 payment. The entire $500,000 payment is treated as an excess parachute payment.

Q–34: What is the base amount?

A–34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity as defined in Q/A–21 of this section) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. *See* Q/A–35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period. *See* Q/A–35 for the definition of base period.

(e) The following example illustrates the principles of this A–34:

Example. A disqualified individual, D, receives an annual salary of $500,000 per year during the 5-year base period. D defers $100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is $400,000 ($400,000 × (5/5)).

Q–35: What is the base period?

A–35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A–27, Q/A–28, or Q/A–29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A–21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A–34 of this section and this Q/A–35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. D's base amount is $120,000, ((3 × $30,000) + $120,000 + $150,000)/3.

Example 2. Assume the same facts as in *Example 1*, except that D also received a $60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is $140,000, (($60,000 + (3 × $30,000)) + $120,000 + $150,000) / 3. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives $30,000 per year for E's services. In 2006, E becomes an officer of X. E's includible compensation from Corporation X is $250,000 for 2006 and 2007, and $300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is $140,000 ((2 × $250,000) + (2 × $30,000) / 4).

Q–36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A–21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A–36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which—

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A–36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A–21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of $60,000, a change in the ownership or control of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the $420,000 payment is contingent on the change is not rebutted. Thus, the payment of $420,000 is treated as contingent on the change in ownership or control of Corporation M. In this case, A's base amount is $120,000 (2 × $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A's base amount of $120,000 (3 × $120,000 = $360,000), the payment is a parachute payment.

Example 2. Assume the same facts as in *Example 1*, except that A also receives a signing bonus of $50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership or control. When the change in ownership or control occurs on July 1, 2006, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000 ($50,000 + (2 × $60,000)). Because the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A's base amount of $170,000 (3 × $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q–37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A–37: (a) No, the term *parachute payment* also includes any payment (other than a payment exempted under Q/A–6 or Q/A–8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made—

(1) Pursuant to an agreement that violates any generally enforced Federal or state securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A–37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A–37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A–22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A–30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A–38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d) The rules in paragraph (b) of this A–37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A–37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A–37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in *Example 1,* except that the present value of the first payment is equal to 2 times A's base amount. If the second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed 3 times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in *Example 3,* except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q–38: How is the amount of an excess parachute payment computed?

A–38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. *See* Q/A–31, Q/A–32, and Q/A–33 of this section for rules on determining present value and Q/A–34 of this section for the definition of *base amount.*

(b) The following example illustrates the principles of this A–38:

Example. An individual with a base amount of $100,000 is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) × $100,000) and $60,000 (($300,000/$500,000) × $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 − $40,000) and that of the second is $340,000 ($400,000 − $60,000).

Q–39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A–39: (a) Generally, yes. Except in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A–24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A–6 through Q/A–9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A–39:

Example 1. Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000—$100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example 2. Assume the same facts as in *Example 1,* except that the full amount of the $600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of $500,000 is reduced to zero by $500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q–40: How is it determined whether payments are reasonable compensation?

A–40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following—

(1) The nature of the services rendered or to be rendered;

(2) The individual's historic compensation for performing such services; and

(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q–41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A–41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A–26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or are to be rendered on or after, the date of the change in ownership or control. Q/A–46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A–41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of *parachute payment* under Q/A–8 of this section.

Q–42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A–42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control—

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2) If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the

same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. However, except as provided in paragraph (b) and (c) of this A–42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (*e.g.*, a covenant not to compete) is an agreement for the performance of personal services for purposes of this A–42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A–44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control—

(1) The contract was not entered into, amended, or renewed in contemplation of the change in ownership or control;

(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer (including involuntary termination or constructive discharge); and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A–44 of this section for rules regarding damages for a failure to make severance payments.

(d) The following examples illustrate the principles of this A–42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 2. Assume the same facts as in *Example 1*, except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 3. Assume the same facts as in *Example 1*, except that under the new contract A agrees to perform consulting services to Corporation N, when and if Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A–42. Assuming the requirements of paragraph (a) of this A–42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Example 4. Assume the same facts as in *Example 1,* except that instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. Assume the same facts as in *Example 1,* except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of *parachute payment* pursuant to Q/A–9 of this section.

Q–43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A–43: Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q–44: May severance payments be treated as reasonable compensation?

A–44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term *severance payment* means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b) The following example illustrates the principles of this A–44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of $200,000 for the first year of the contract, and for each succeeding year, an annual salary that is $100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives $700,000 ($300,000 for the second year of the contract plus $400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the $700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the $700,000 is a parachute payment.

Miscellaneous Rules

Q–45: How is the term *corporation* defined?

A–45: For purposes of this section, the term *corporation* has the meaning prescribed by section 7701(a)(3) and §301.7701–2(b) of this Chapter. For example, a *corporation,* for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704(a); an entity described in §301.7701–3(c)(1)(v)(A) of this Chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q–46: How is an affiliated group treated?

A–46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A–6, Q/A–7 of this section (except as provided therein)), payor of parachute payments (Q/A–10 of this section), disqualified individuals (Q/A–15 through Q/A–21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A–26 of this section (except as provide therein)), change in ownership or control (Q/A–27, 28, and 29 of this section), and reasonable compensation (Q/A–42, 43, and 44 of this section).

Effective Date

Q–47: What is the general effective date of section 280G?

A–47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A–47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a *supplement* to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A–47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented—

(i) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A–47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following—

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q–48: What is the effective date of this section?

A–48: This section applies to any payments that are contingent on a change in ownership or control if the change in ownership or control occurs on or after January 1, 2004. Taxpayers may rely on these regulations after August 4, 2003, for the treatment of any parachute payment.

[T.D. 9083, 68 FR 45750, Aug. 4, 2003; T.D. 9083, 68 FR 59114, Oct. 14, 2003]

§ 1.280H–0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 280H.

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[T.D. 8205, 53 FR 19711, May 27, 1988]

§ 1.280H–1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) *Introduction.* This section applies to any taxable year that a personal service corporation has a section 444 election in effect (an ''applicable election year''). For purposes of this section, the term *personal service corporation* has the same meaning given such term in § 1.441–3(c).

(b) *Limitation on certain deductions of personal service corporations*—(1) *In general.* If, for any applicable election year, a personal service corporation does not satisfy the minimum distribution requirement in paragraph (c) of this section, the deduction otherwise allowable under chapter 1 of the Internal Revenue Code of 1986 (the Code) for applicable amounts, as defined in paragraph (b)(4) of this section, shall not exceed the maximum deductible amount, as defined in paragraph (d) of this section.

(2) *Carryover of nondeductible amounts.* Any amount not allowed as a deduction in an applicable election year under paragraph (b)(1) of this section shall be allowed as a deduction in the succeeding taxable year.

(3) *Disallowance inapplicable for certain purposes.* The disallowance of deductions under paragraph (b)(1) of this section shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to corporations used to avoid income tax on shareholders) nor for determining whether the compensation of employee-owners is reasonable. Thus, for example, in determining whether a personal service corporation is subject to the accumulated earnings tax imposed by section 531, deductions disallowed under paragraph (b)(1) of this section are treated as allowed in computing accumulated taxable income.

(4) *Definition of applicable amount*—(i) *In general.* For purposes of section 280H and the regulations thereunder, the term *applicable amount* means, with respect to a taxable year, any amount that is otherwise deductible by a personal service corporation in such year and includable at any time, directly or indirectly, in the gross income of a taxpayer that during such year is an employee-owner. Thus, an amount includable in the gross income of an employee-owner will be considered an applicable amount even though such employee owns no stock of the corporation on the date the employee includes the amount in income. See *Example 1* in paragraph (b)(4)(iii) of this section.

(ii) *Special rule for certain indirect payments.* For purposes of paragraph (b)(4)(i) of this section, amounts are indirectly includable in the gross income of an employee-owner of a personal service corporation that has made a section 444 election (an electing personal service corporation) if the amount is includable in the gross income of—

(A) The spouse (other than a spouse who is legally separated from the partner or shareholder under a decree of divorce or separate maintenance) or child (under age 14) of such employee-owner, or

(B) A corporation more than 50 percent (measured by fair market value) of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners), of the electing personal service corporation, or

(C) A partnership more than 50 percent of the profits and capital of which is owned by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to such employee-owners) of the electing personal service corporation, or

(D) A trust more than 50 percent of the beneficial ownership of which is owned in the aggregate by employee-owners (and individuals related under paragraph (b)(4)(ii)(A) of this section to any such employee-owners), of the electing personal service corporation.

For purposes of this paragraph (b)(4)(ii), ownership by any person described in this paragraph (b)(4)(ii) shall be treated as ownership by the employee-owners of the electing personal service corporation. Paragraph (b)(4)(ii)(B) of this section will not apply if the corporation has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Similarly, paragraph (b)(4)(ii)(C) of this section will not apply if the partnership has made a section 444 election to use the same taxable year as that of the electing personal service corporation. Notwithstanding the general effective date provision of paragraph (f) of this section, this paragraph (b)(4)(ii) is effective for amounts deductible on or after June 1, 1988.

(iii) *Example*. The provisions of paragraph (b)(4) of this section may be illustrated by the following examples.

Example 1. A is an employee of P, an accrual basis personal service corporation with a taxable year ending September 30. P makes a section 444 election for its taxable year beginning October 1, 1987. On October 1, 1987, A owns no stock of P; However, on March 31, 1988, A acquires 10 of the 200 outstanding shares of P stock. During the period October 1, 1987 to March 31, 1988, A earned $40,000 of compensation as an employee of P. During the period April 1, 1988 to September 30 1988, A earned $60,000 of compensation as an employee-owner of P. If paragraph (b) of this section does not apply, P would deduct for its taxable year ended September 30, 1988 the $100,000 earned by A during such year. Based upon these facts, the $100,000 otherwise deductable amount is considered an applicable amount under this section.

Example 2. I1 and I2, calendar year individuals, are employees of PSC1, a personal service corporation that has historically used a taxable year ending January 31. I1 and I2 also own all the stock, and are employees, of PSC2, a calendar year personal service corporation. For its taxable years beginning February 1, 1987, 1988, and 1989, PSC1 has a section 444 election in effect to use a January 31 taxable year. During its taxable years beginning February 1, 1986, 1987, and 1988, PSC1 deducted $10,000, $11,000, and $12,000, respectively, that was included in PSC2's gross income. Furthermore, of the $12,000 deducted by PSC1 for its taxable year beginning February 1, 1988, $7,000 was deducted during the period June 1, 1988 to January 31, 1989. Pursuant to paragraph (b)(4)(ii)(B) of this section, the $7,000 deducted by PSC1 on or after June 1, 1988, and included in PSC2's gross income is considered an applicable amount for PSC1's taxable year beginning February 1, 1988. Amounts deducted by PSC1 prior to June 1, 1988, are not subject to paragraph (b)(4)(ii)(B) of this section.

Example 3. The facts are the same as in *Example 2*, except that for its taxable years beginning February 1, 1987, 1988, and 1989, PSC2 has a section 444 election in effect to use a January 31 taxable year. Since both PSC1 and PSC2 have the same taxable year and both have section 444 elections in effect, paragraph (b)(4)(ii)(B) of this section does not apply to the $7,000 deducted by PSC1 for its taxable year beginning February 1, 1988.

(c) *Minimum distribution requirement*—(1) *Determination of whether requirement satisfied*—(i) *In general*. A personal service corporation meets the minimum distribution requirement of this paragraph (c) for an applicable election year if, during the deferral period of such taxable year, the applicable amounts (determined without regard to paragraph (b)(2) of this section) for all employee-owners in the aggregate equal or exceed the lesser of—

(A) The amount determined under the ''preceding year test'' (see paragraph (c)(2) of this section), or

(B) The amount determined under the ''3-year average test'' (see paragraph (c)(3) of this section).

The following example illustrates the application of this paragraph (c)(1)(i).

Example. Q, an accrual-basis personal service corporation, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. Q has 4 employee-owners, B, C, D, and E. For Q's applicable election year beginning February 1, 1987 and ending January 31, 1988, B earns $6,000 a month plus a $45,000 bonus on January 15, 1988; C earns $5,000 a month plus a $40,000 bonus on January 15, 1988; D and E each earn $4,500 a month plus a $4,000 bonus on January 15, 1988. Q meets the minimum distribution requirement for such applicable election year if the applicable amounts during the deferral period (*i.e.*, $220,000) equal or exceed the amount determined under the preceding year test or the 3-year average test.

(ii) *Employee-owner defined.* For purposes of section 280H and the regulations thereunder, a person is an employee-owner of a corporation for a taxable year if—

(A) On any day of the corporation's taxable year, the person is an employee of the corporation or performs personal services for or on behalf of the corporation, even if the legal form of that person's relationship to the corporation is that of an independent contractor, and

(B) On any day of the corporation's taxable year, the person owns any outstanding stock of the corporation.

(2) *Preceding year test*—(i) *In general.* The amount determined under the preceding year test is the product of—

(A) The applicable amounts during the taxable year preceding the applicable election year (the "preceding taxable year"), divided by the number of months (but not less than one) in the preceding taxable year, multiplied by

(B) The number of months in the deferral period of the applicable election year.

(ii) *Example.* The provisions of paragraph (c)(2) of this section may be illustrated by the following example.

Example. R, a personal service corporation, has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, R makes a section 444 election to retain its January 31 taxable year. R is an accrual basis taxpayer and has one employee-owner, F. For R's taxable year ending January 31, 1987, F earns $5,000 a month plus a $40,000 bonus on January 15, 1987. The amount determined under the preceding year test for R's applicable election year beginning February 1, 1987 is $91,667 ($100,000, the applicable amounts during R's taxable year ending January 31, 1987, divided by 12, the number of months in R's taxable year ending January 31, 1987, multiplied by 11, the number of months in R's deferral period for such year).

(3) *3-year average test*—(i) *In general.* The amount determined under the 3-year average test is the applicable percentage multiplied by the adjusted taxable income for the deferral period of the applicable election year.

(ii) *Applicable percentage.* The term *applicable percentage* means the percentage (not in excess of 95 percent) determined by dividing—

(A) The applicable amounts during the 3 taxable years of the corporation (or, if fewer, the taxable years the corporation has been in existence) immediately preceding the applicable election year, by

(B) The adjusted taxable income of such corporation for such 3 taxable years (or, if fewer, the taxable years of existence).

(iii) *Adjusted taxable income*—(A) *In general.* The term *adjusted taxable income* means taxable income determined without regard to applicable amounts.

(B) *Determination of adjusted taxable income for the deferral period of the applicable election year.* Adjusted taxable income for the deferral period of the applicable election year equals the adjusted taxable income that would result if the personal service corporation filed an income tax return for the deferral period of the applicable election year under its normal method of accounting. However, a personal service corporation may make a reasonable estimate of such amount.

(C) *NOL carryovers.* For purposes of determining adjusted taxable income for any period, any NOL carryover shall be reduced by the amount of such carryover that is attributable to the deduction of applicable amounts. The portion of the NOL carryover attributable to the deduction of applicable amounts is the difference between the NOL carryover computed with the deduction of such amounts and the NOL carryover computed without the deduction of such amounts. For purposes of determining the adjusted taxable income for the deferral period, an NOL carryover to the applicable election year, reduced as provided in this paragraph (c)(3)(iii)(C), shall be allowed first against the income of the deferral period.

(D) *Examples.* The provisons of this paragraph (c)(3)(iii) may be illustrated by the following examples.

Example 1. S is a personal service corporation that has historically used a taxable year ending January 31. For its taxable year beginning February 1, 1987, S makes a section 444 election to retain its taxable year ending January 31. S does not satisfy the minimum distribution requirement for its first applicable election year, and the applicable amounts for that year exceed the maximum deductible amount by $54,000. Under paragraph (b)(2) of this section, the $54,000 excess is carried over to S's taxable year beginning February 1, 1988. Furthermore, if S continues its section 444 election for its taxable year beginning February 1, 1988, and desires to use the 3-year average test provided in this paragraph for such year, pursuant to paragraph (c)(3)(iii)(A) of this section the $54,000 will not be allowed to reduce adjusted taxable income for such year. See also section 280H(e) regarding the disallowance of net operating loss carrybacks to (or from) any taxable year of a corporation personal service election under section 444 applies.

Example 2. T, a personal service corporation with a section 444 election in effect, is determining whether it satisfies the 3-year average test for its second applicable election year. T had a net operating loss (NOL) for its first applicable election year of $45,000. The NOL resulted from $150,000 of gross income less the sum of $96,000 of salary, $45,000 of other expenses, and $54,000 of deductible applicable amounts. Pursuant to paragraph (c)(3)(iii)(C) of this section, the entire amount of the $45,000 NOL is attributable to applicable amounts since the applicable amounts deducted in arriving at the NOL (*i.e.,* $54,000) were greater than the NOL (*i.e.,* $45,000). Thus, for purposes of computing the adjusted taxable income for the deferral period of T's second applicable election year, the NOL carryover to that year is $0 ($45,000 NOL less $45,000 amount of NOL attributable to applicable amounts).

(d) *Maximum deductible amount*—(1) *In general.* For purposes of this section, the term *maximum deductible amount* means the sum of—

(i) The applicable amounts during the deferral period of the applicable election year, plus

(ii) An amount equal to the product of—

(A) The amount determined under paragraph (d)(1)(i) of this section divided by the number of months in the deferral period of the applicable election year, multiplied by

(B) The number of months in the nondeferral period of the applicable election year. For purposes of the preceding sentence, the term *nondeferral period* means the portion of the applicable election year that occurs after the portion of such year constituting the deferral period.

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

Example. U, an accrual basis personal service corporation with a taxable year ending January 31, makes a section 444 election to retain a year ending January 31 for its taxable year beginning February 1, 1987. For its applicable election year beginning February 1, 1987, U does not satisfy the minimum distribution requirement in paragraph (c) of this section. Furthermore, U has 3 employee-owners, G, H, and I. G and H have been employee-owners of U for 10 years. Although I has been an employee of U for 4 years, I did not become an employee-owner until December 1, 1987, when I acquired 5 of the 20 outstanding shares of U stock. For U's applicable election year beginning February 1, 1987, G earns $5,000 a month plus a $40,000 bonus on January 15, 1988, and H and I each earn $4,000 a month plus a $32,000 bonus on January 15, 1988. Thus, the total of the applicable amounts during the deferral period of the applicable election year beginning February 1, 1987 is $143,000. Based on these facts, U's deduction for applicable amounts is limited to $156,000, determined as follows—$143,000 (applicable amounts during the deferral period) plus $13,000 (applicable amounts during the deferral period, divided by the number of months in the deferral period, multiplied by the number of months in the nondeferral period).

(e) *Special rules and definition*—(1) *Newly organized personal service corporations.* A personal service corporation is deemed to satisfy the preceding year test and the 3-year average test for the first year of the corporation's existence.

(2) *Existing corporations that become personal service corporations.* If an existing corporation becomes a personal service corporation and makes a section 444 election, the determination of whether the corporation satisfies the preceding year test and the 3-year average test is made by treating the corporation as though it were a personal service corporation for each of the 3

years preceding the applicable election year.

(3) *Disallowance of NOL carryback.* No net operating loss carryback shall be allowed to (or from) any applicable election year of a personal service corporation.

(4) *Deferral period.* For purposes of section 280H and the regulations thereunder, the term *deferral period* has the same meaning as under §1.444–1T(b)(4).

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

Example 1. V is a personal service corporation with a taxable year ending September 30. V makes a section 444 election for its taxable year beginning October 1, 1987, and incurs a net operating loss (NOL) for such year. Because an NOL is not allowed to be carried back from an applicable election year, V may not carry back the NOL from its first applicable election year to reduce its 1985, 1986, or 1987 taxable income.

Example 2. W, a personal service corporation, commences operations on July 1, 1990. Furthermore, for its taxable year beginning July 1, 1990, W makes a section 444 election to use a year ending September 30. Pursuant to paragraph (e)(1) of this section, W satisfies the preceding year test and the 3-year average test for its first year in existence. Thus, W may deduct, without limitation under this section, any applicable amounts for its taxable year beginning July 1, 1990.

Example 3. The facts are the same as in *Example 2.* For its taxable year beginning October 1, 1990, W incurs an NOL and is not a personal service corporation. Furthermore, W desires to carry back the NOL to its preceding taxable year (a year that was an applicable election year). Pursuant to paragraph (e)(3) of this section, W may not carry back an NOL ''to'' its taxable year beginning July 1, and ending September 30, 1990, because such year was an applicable election year.

(f) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19711, May 27, 1988]

TAXABLE YEARS BEGINNING PRIOR TO JANUARY 1, 1986

§ 1.274–5A Substantiation requirements.

(a) *In general.* No deduction shall be allowed for any expenditure with respect to:

(1) Traveling away from home (including meals and lodging) deductible under section 162 or 212,

(2) Any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity, including the items specified in section 274(e), or

(3) Gifts defined in section 274, unless the taxpayer substantiates such expenditure as provided in paragraph (c) of this section. This limitation supersedes with respect to any such expenditure the doctrine of Cohan v. Commissioner (C.C.A. 2d 1930) 39 F. 2d 540. The decision held that, where the evidence indicated a taxpayer incurred deductible travel or entertainment expense but the exact amount could not be determined, the court should make a close approximation and not disallow the deduction entirely. Section 274(d) contemplates that no deduction shall be allowed a taxpayer for such expenditures on the basis of such approximations or unsupported testimony of the taxpayer. For purposes of this section, the term *entertainment* means entertainment, amusement, or recreation, and use of a facility therefore; and the term *expenditure* includes expenses and items (including items such as losses and depreciation).

(b) *Elements of an expenditure*—(1) *In general.* Section 274(d) and this section contemplate that no deduction shall be allowed for any expenditure for travel, entertainment, or a gift unless the taxpayer substantiates the following elements for each such expenditure:

(i) Amount;

(ii) Time and place of travel or entertainment (or use of a facility with respect to entertainment), or date and description of a gift;

(iii) Business purpose; and

(iv) Business relationship to the taxpayer of each person entertained, using an entertainment facility or receiving a gift.

(2) *Travel.* The elements to be proved with respect to an expenditure for travel are:

(i) *Amount.* Amount of each separate expenditure for traveling away from home, such as cost of transportation or lodging, except that the daily cost of the traveler's own breakfast, lunch, and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, for gasoline and oil, and for taxi fares;

(ii) *Time.* Dates of departure and return for each trip away from home, and number of days away from home spent on business;

(iii) *Place.* Destinations or locality of travel, described by name of city or town or other similar designation; and

(iv) *Business purpose.* Business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel.

(3) *Entertainment in general.* Elements to be proved with respect to an expenditure for entertainment are:

(i) *Amount.* Amount of each separate expenditure for entertainment, except that such incidental items as taxi fares or telephone calls may be aggregated on a daily basis;

(ii) *Time.* Date of entertainment;

(iii) *Place.* Name, if any, address or location, and designation of type of entertainment, such as dinner or theater, if such information is not apparent from the designation of the place;

(iv) *Business purpose.* Business reason for the entertainment or nature of business benefit derived or expected to be derived as a result of the entertainment and, except in the case of business meals described in section 274(e)(1), the nature of any business discussion or activity;

(v) *Business relationship.* Occupation or other information relating to the person or persons entertained, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(4) *Entertainment directly preceding or following a substantial and bona fide business discussion.* If a taxpayer claims a deduction for entertainment directly preceding or following a substantial and bona fide business discussion on the ground that such entertainment was associated with the active conduct of the taxpayer's trade or business, the elements to be proved with respect to such expenditure, in addition to those enumerated in subparagraph (3)(i), (ii), (iii), and (v) of this paragraph, are:

(i) *Time.* Date and duration of business discussion;

(ii) *Place.* Place of business discussion;

(iii) *Business purpose.* Nature of business discussion, and business reason for the entertainment or nature of business benefit derived or expected to be derived as the result of the entertainment;

(iv) *Business relationship.* Identification of those persons entertained who participated in the business discussion.

(5) *Gifts.* Elements to be proved with respect to an expenditure for a gift are:

(i) *Amount.* Cost of the gift to the taxpayer;

(ii) *Time.* Date of the gift;

(iii) *Description.* Description of the gift;

(iv) *Business purpose.* Business reason for the gift or nature of business benefit derived or expected to be derived as a result of the gift; and

(v) *Business relationship.* Occupation or other information relating to the recipient of the gift, including name, title, or other designation, sufficient to establish business relationship to the taxpayer.

(c) *Rules for substantiation*—(1) *In general.* A taxpayer must substantiate each element of an expenditure (described in paragraph (b) of this section) by adequate records or by sufficient evidence corroborating his own statement except as otherwise provided in this section. Section 274(d) contemplates that a taxpayer will maintain and produce such substantiation as will constitute clear proof of an expenditure for travel, entertainment, or gifts referred to in section 274. A record of the elements of an expenditure made at or near the time of the expenditure, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the corroborative evidence required to support a statement not made at or near the time of the expenditure must have a high degree of probative value to elevate such statement and evidence to the level of credibility reflected by a record made at or near the time of the expenditure supported by sufficient documentary evidence. The substantiation requirements of section 274(d) are designed to encourage taxpayers to maintain the records, together with documentary evidence, as provided in subparagraph (2) of this paragraph. To obtain a deduction for an expenditure for travel, entertainment, or gifts, a taxpayer must substantiate, in accordance with the provisions of this paragraph, each element of such an expenditure.

(2) *Substantiation by adequate records*—(i) *In general.* To meet the ''adequate records'' requirements of section 274(d), a taxpayer shall maintain an account book, diary, statement of expense or similar record (as provided in subdivision (ii) of this subparagraph) and documentary evidence (as provided in subdivision (iii) of this subparagraph) which, in combination, are sufficient to establish each element of an expenditure specified in paragraph (b) of this section. It is not necessary to record information in an account book, diary, statement of expense or similar record which duplicates information reflected on a receipt so long as such account book and receipt complement each other in an orderly manner.

(ii) *Account book, diary, etc.* An account book, diary, statement of expense or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is made at or near the time of the expenditure.

(*a*) *Made at or near the time of the expenditure.* For purposes of this section, the phrase *made at or near the time of the expenditure* means the elements of an expenditure are recorded at a time when, in relation to the making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure, such as the amount, time, place and business purpose of the expenditure and business relationship to the taxpayer of any person entertained. An expense account statement which is a transcription of an account book, diary, or similar record prepared or maintained in accordance with the provisions of this subdivision shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer or by an independent contractor to his client or customer in the regular course of good business practice.

(*b*) *Substantiation of business purpose.* In order to constitute an adequate record of business purpose within the meaning of section 274(d) and this subparagraph, a written statement of business purpose generally is required. However, the degree of substantiation necessary to establish business purpose will vary depending upon the facts and circumstances of each case. Where the business purpose of an expenditure is evident from the surrounding facts and circumstances, a written explanation of such business purpose will not be required. For example, in the case of a salesman calling on customers on an established sales route, a written explanation of the business purpose of such travel ordinarily will not be required. Similarly, in the case of a business meal described in section 274(e)(1), if the business purpose of such meal is evident from the business relationship to the taxpayer of the persons entertained and other surrounding circumstances, a written explanation of such business purpose will not be required.

(*c*) *Confidential information.* If any information relating to the elements of an expenditure, such as place, business purpose or business relationship, is of a confidential nature, such information need not be set forth in the account book, diary, statement of expense or similar record, provided such information is recorded at or near the time of the expenditure and is elsewhere available to the district director to substantiate such element of the expenditure.

(iii) *Documentary evidence.* Documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure shall be required for:

(*a*) Any expenditure for lodging while traveling away from home, and

(*b*) Any other expenditure of $25 or more, except, for transportation charges, documentary evidence will not be required if not readily available.

Provided, however, that the Commissioner, in his discretion, may prescribe rules waiving such requirements in circumstances where he determines it is impracticable for such documentary evidence to be required. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the following: name, location, date, and separate amounts for charges such as for lodging, meals, and telephone. Similarly, a restaurant receipt is sufficient to support an expenditure for a business meal if it contains the following: name and location of the restaurant, the date and amount of the expenditure, and, if a charge is made for an item other than meals and beverages, an indication that such is the case. A document may be indicative of only one (or part of one) element of an expenditure. Thus, a cancelled check, together with a bill from the payee, ordinarily would establish the element of cost. In contrast, a cancelled check drawn payable to a named payee would not by itself support a business expenditure without other evidence showing that the check was used for a certain business purpose.

(iv) *Retention of documentary evidence.* The Commissioner may, in his discretion, prescribe rules under which an employer may dispose of documentary evidence submitted to him by employees who are required to, and do, make an adequate accounting to the employer (within the meaning of paragraph (e)(4) of this section) if the employer maintains adequate accounting procedures with respect to such employees (within the meaning of paragraph (e)(5) of this section).

(v) *Substantial compliance.* If a taxpayer has not fully substantiated a particular element of an expenditure, but the taxpayer establishes to the satisfaction of the district director that he has substantially complied with the *adequate records* requirements of this subparagraph with respect to the expenditure, the taxpayer may be permitted to establish such element by evidence which the district director shall deem adequate.

(3) *Substantiation by other sufficient evidence.* If a taxpayer fails to establish to the satisfaction of the district director that he has substantially complied with the ''adequate records'' requirements of subparagraph (2) of this paragraph with respect to an element of an expenditure, then, except as otherwise provided in this paragraph, the taxpayer must establish such element:

(i) By his own statement, whether written or oral, containing specific information in detail as to such element; and

(ii) By other corroborative evidence sufficient to establish such element.

If such element is the description of a gift, or the cost, time, place, or date of an expenditure, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of persons entertained or other witness setting forth detailed information about such element, or the documentary evidence described in subparagraph (2) of this paragraph. If such element is either the business relationship to the taxpayer of persons entertained or the business purpose of an expenditure, the corroborative evidence may be circumstantial evidence.

(4) *Substantiation in exceptional circumstances.* If a taxpayer establishes that, by reason of the inherent nature of the situation in which an expenditure was made:

(i) He was unable to obtain evidence with respect to an element of the expenditure which conforms fully to the ''adequate records'' requirements of subparagraph (2) of this paragraph,

(ii) He is unable to obtain evidence with respect to such element which conforms fully to the ''other sufficient evidence'' requirements of subparagraph (3) of this paragraph, and

(iii) He has presented other evidence, with respect to such element, which possesses the highest degree of probative value possible under the circumstances, such other evidence shall be considered to satisfy the substantiation requirements of section 274(d) and this paragraph.

(5) *Loss of records due to circumstances beyond control of taxpayer.* Where the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire, flood,

earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures.

(6) *Special rules*—(i) *Separate expenditure*—(*a*) *In general.* For the purposes of this section, each separate payment by the taxpayer shall ordinarily be considered to constitute a separate expenditure. However, concurrent or repetitious expenses of a similar nature occurring during the course of a single event shall be considered a single expenditure. To illustrate the above rules, where a taxpayer entertains a business guest at dinner and thereafter at the theater, the payment for dinner shall be considered to constitute one expenditure and the payment for the tickets for the theater shall be considered to constitute a separate expenditure. Similarly, if during a day of business travel a taxpayer makes separate payments for breakfast, lunch, and dinner, he shall be considered to have made three separate expenditures. However, if during entertainment at a cocktail lounge the taxpayer pays separately for each serving of refreshments, the total amount expended for the refreshments will be treated as a single expenditure. A tip may be treated as a separate expenditure.

(*b*) *Aggregation.* Except as otherwise provided in this section, the account book, diary, statement of expense, or similar record required by subparagraph (2)(ii) of this paragraph shall be maintained with respect to each separate expenditure and not with respect to aggregate amounts for two or more expenditures. Thus, each expenditure for such items as lodging and air or rail travel shall be recorded as a separate item and not aggregated. However, at the option of the taxpayer, amounts expended for breakfast, lunch, or dinner, may be aggregated. A tip or gratuity which is related to an underlying expense may be aggregated with such expense. For other provisions permitting recording of aggregate amounts in an account book, diary, statement of expense or similar record see paragraph (b)(2)(i) and (b)(3) of this section (relating to incidental costs of travel and entertainment).

(ii) *Allocation of expenditure.* For purposes of this section, if a taxpayer has established the amount of an expenditure, but is unable to establish the portion of such amount which is attributable to each person participating in the event giving rise to the expenditure, such amount shall ordinarily be allocated to each participant on a pro rata basis, if such determination is material. Accordingly, the total number of persons for whom a travel or entertainment expenditure is incurred must be established in order to compute the portion of the expenditure allocable to each such person.

(iii) *Primary use of a facility.* Section 274(a) (1)(B) and (2)(C) denies a deduction for any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred at any time with respect to a club, used in connection with an entertainment activity unless the taxpayer establishes that the facility (including a club) was used primarily for the furtherance of his trade or business. A determination whether a facility before January 1, 1979, or a club at any time was used primarily for the futherance of the taxpayer's trade or business will depend upon the facts and circumstances of each case. In order to establish that a facility was used primarily for the furtherance of his trade or business, the taxpayer shall maintain records of the use of the facility, the cost of using the facility, mileage or its equivalent (if appropriate), and such other information as shall tend to establish such primary use. Such records of use shall contain:

(*a*) For each use of the facility claimed to be in furtherance of the taxpayer's trade or business, the elements of an expenditure specified in paragraph (b) of this section, and

(*b*) For each use of the facility not in furtherance of the taxpayer's trade or business, an appropriate description of such use, including cost, date, number of persons entertained, nature of entertainment and, if applicable, information such as mileage or its equivalent. A notation such as ''personal use'' or ''family use'' would, in the case of such use, be sufficient to describe the nature of entertainment.

If a taxpayer fails to maintain adequate records concerning a facility which is likely to serve the personal purposes of the taxpayer, it shall be presumed that the use of such facility was primarily personal.

(iv) *Additional information.* In a case where it is necessary to obtain additional information, either:

(*a*) To clarify information contained in records, statements, testimony, or documentary evidence submitted by a taxpayer under the provisions of paragraph (c)(2) or (c)(3) of this section, or

(*b*) To establish the reliability or accuracy of such records, statements, testimony, or documentary evidence, the district director may, notwithstanding any other provision of this section, obtain such additional information as he determines necessary to properly implement the provisions of section 274 and the regulations thereunder by personal interview or otherwise.

(7) *Specific exceptions.* Except as otherwise prescribed by the Commissioner, substantiation otherwise required by this paragraph is not required for:

(i) Expenses described in section 274 (e)(2) relating to food and beverages for employees, section 274(e)(3) relating to expenses treated as compensation, section 274(e)(8) relating to items available to the public, and section 274(e)(9) relating to entertainment sold to customers, and

(ii) Expenses described in section 274(e)(5) relating to recreational, etc., expenses for employees, except that a taxpayer shall keep such records or other evidence as shall establish that such expenses were for activities (or facilities used in connection therewith) primarily for the benefit of employees other than employees who are officers, shareholders or other owners (as defined in section 274(e)(5)), or highly compensated employees.

(d) *Disclosure on returns.* The Commissioner may, in his discretion, prescribe rules under which any taxpayer claiming a deduction for entertainment, gifts, or travel or any other person receiving advances, reimbursements, or allowances for such items, shall make disclosure on his tax return with respect to such items. The provisions of this paragraph shall apply notwithstanding the provisions of paragraph (e) of this section.

(e) *Reporting and substantiation of expenses of certain employees for travel, entertainment, and gifts*—(1) *In general.* The purpose of this paragraph is to provide rules for reporting and substantiation of certain expenses paid or incurred by taxpayers in connection with the performance of services as employees. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, or gifts which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 274(c). Thus, the term *business expenses* does not include personal, living or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and advances, reimbursements, or allowances for such expenditures must be reported as income by the employee.

(2) *Reporting of expenses for which the employee is required to make an adequate accounting to his employer*—(i) *Reimbursements equal to expenses.* For purposes of computing tax liability, an employee need not report on his tax return business expenses for travel, transportation, entertainment, gifts, and similar purposes, paid or incurred by him solely for the benefit of his employer for which he is required to, and does, make an adequate accounting to his employer (as defined in subparagraph (4) of this paragraph) and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided that the total amount of such advances, reimbursements, and charges is equal to such expenses.

(ii) *Reimbursements in excess of expenses.* In case the total of the amounts charged directly or indirectly to the employer or received from the employer as advances, reimbursements, or otherwise, exceeds the business expenses paid or incurred by the employee and the employee is required to, and does, make an adequate accounting to his employer for such expenses, the employee must include such excess (including amounts received for expenditures not deductible by him) in income.

(iii) *Expense in excess of reimbursements.* If an employee incurs deductible business expenses on behalf of his employer which exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee wishes to claim a deduction for such excess, he must:

(*a*) Submit a statement as part of his tax return showing all of the information required by subparagraph (3) of this paragraph, and,

(*b*) Maintain such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(3) *Reporting of expenses for which the employee is not required to make an adequate accounting to his employer.* If the employee is not required to make an adequate accounting to his employer for his business expenses or, though required, fails to make an adequate accounting for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(i) The total of all amounts received as advances or reimbursements from his employer, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such categories as transportation, meals and lodging while away from home overnight, entertainment, gifts, and other business expenses.

In addition, he must maintain such records and supporting evidence as will substantiate each element of an expenditure (described in paragraph (b) of this section) in accordance with paragraph (c) of this section.

(4) *Definition of an ''adequate accounting'' to the employer.* For purposes of this paragraph an adequate accounting means the submission to the employer of an account book, diary, statement of expense, or similar record maintained by the employee in which the information as to each element of an expenditure (described in paragraph (b) of this section) is recorded at or near the time of the expenditure, together with supporting documentary evidence, in a manner which conforms to all the ''adequate records'' requirements of paragraph (c)(2) of this section. An adequate accounting requires that the employee account for all amounts received from his employer during the taxable year as advances, reimbursements, or allowances (including those charged directly or indirectly to the employer through credit cards or otherwise) for travel, entertainment, and gifts. The methods of substantiation allowed under paragraph (c)(4) or (c)(5) of this section also will be considered to be an adequate accounting if the employer accepts an employee's substantiation and establishes that such substantiation meets the requirements of such paragraph (c)(4) or (c)(5). For purposes of an adequate accounting the method of substantiation allowed under paragraph (c)(3) of this section will not be permitted.

(5) *Substantiation of expenditures by certain employees.* An employee who makes an adequate accounting to his employer within the meaning of this paragraph will not again be required to substantiate such expense account information except in the following cases:

(i) An employee whose business expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(ii) An employee who is related to his employer within the meaning of section 267(b) but for this purpose the percentage referred to in section 267(b)(2) shall be 10 percent; and

(iii) Employees in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by such employees are not adequate, or where it cannot be determined that such procedures are adequate. The district director will determine whether the employer's accounting procedures are adequate by considering the facts and circumstances of each case, including the use of proper internal controls.

For example, an employer should require that an expense account must be verified and approved by a responsible person other than the person incurring such expenses. Accounting procedures will be considered inadequate to the extent that the employer does not require an adequate accounting from his employees as defined in subparagraph (4) of this paragraph, or does not maintain such substantiation. To the extent an employer fails to maintain adequate accounting procedures he will thereby obligate his employees to separately substantiate their expense account information.

(f) *Substantiation by reimbursement arrangements or per diem, mileage, and other traveling allowances.* The Commissioner may, in his discretion, prescribe rules under which:

(1) Reimbursement arrangements covering ordinary and necessary expenses of traveling away from home (exclusive of transportation expenses to and from destination),

(2) Per diem allowances providing for ordinary and necessary expenses of traveling away from home (exclusive of transportation costs to and from destination), and

(3) Mileage allowances providing for ordinary and necessary expenses of transportation while traveling away from home, will, if in accordance with reasonable business practice, be regarded as equivalent to substantiation by adequate records or other sufficient evidence for purposes of paragraph (c) of this section of the amount of such traveling expenses and as satisfying, with respect to the amount of such traveling expenses, the requirements of an adequate accounting to the employer for purposes of paragraph (e)(4) of this section. If the total travel allowance received exceeds the deductible traveling expenses paid or incurred by the employee, such excess must be reported as income on the employee's return. See paragraph (h) of this section relating to the substantiation of meal expenses while traveling.

(g) *Reporting and substantiation of certain reimbursements of persons other than employees*—(1) *In general.* The purpose of this paragraph is to provide rules for the reporting and substantiation of certain expenses for travel, entertainment, and gifts paid or incurred by one person (hereinafter termed ''independent contractor'') in connection with services performed for another person other than an employer (hereinafter termed ''client or customer'') under a reimbursement or other expense allowance arrangement with such client or customer. For purposes of this paragraph, the term *business expenses* means ordinary and necessary expenses for travel, entertainment, or gifts which are deductible under section 162, and the regulations thereunder, to the extent not disallowed by section 274(c). Thus, the term *business expenses* does not include personal, living or family expenses disallowed by section 262 or travel expenses disallowed by section 274(c), and reimbursements for such expenditures must be reported as income by the independent contractor. For purposes of this paragraph, the term *reimbursements* means advances, allowances, or reimbursements received by an independent contractor for travel, entertainment, or gifts, in connection with the performance by him of services for his client or customer, under a reimbursement or other expense allowance arrangement with his client or customer, and includes amounts charged directly or indirectly to the client or customer through credit card systems or otherwise. See paragraph (h) of this section relating to the substantiation of meal expenses while traveling.

(2) *Substantiation by independent contractors.* An independent contractor shall substantiate, with respect to his reimbursements, each element of an expenditure (described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section; and, to the extent he does not so substantiate, he shall include such reimbursements in income. An independent contractor shall so substantiate a reimbursement for entertainment regardless of whether he accounts (within the meaning of subparagraph (3) of this paragraph) for such entertainment.

(3) *Accounting to a client or customer under section 274(e)(4)(B).* Section 274(e)(4)(B) provides that section 274(a) (relating to disallowance of expenses for entertainment) shall not apply to

expenditures for entertainment for which an independent contractor has been reimbursed if the independent contractor accounts to his client or customer to the extent provided by section 274(d). For purposes of section 274(e)(4)(B), an independent contractor shall be considered to account to his client or customer for an expense paid or incurred under a reimbursement or other expense allowance arrangement with his client or customer if, with respect to such expense for entertainment, he submits to his client or customer adequate records or other sufficient evidence conforming to the requirements of paragraph (c) of this section.

(4) *Substantiation by client or customer*. A client or customer shall not be required to substantiate, in accordance with the requirements of paragraph (c) of this section, reimbursements to an independent contractor for travel and gifts, or for entertainment unless the independent contractor has accounted to him (within the meaning of section 274(e)(4)(B) and subparagraph (3) of this paragraph) for such entertainment. If an independent contractor has so accounted to a client or customer for entertainment, the client or customer shall substantiate each element of the expenditure (as described in paragraph (b) of this section) in accordance with the requirements of paragraph (c) of this section.

(h) *Authority for an optional method of computing meal expenses while traveling*. The Commissioner may establish a method under which a taxpayer may elect to use a specified amount or amounts for meals while traveling in lieu of substantiating the actual cost of meals. The taxpayer would not be relieved of substantiating the actual cost of other travel expenses as well as the time, place, and business purpose of the travel. See paragraph (b)(2) and (c) of this section.

(i) *Effective date*—(1) *In general*. Section 274(d) and this section apply with respect to taxable years ending after December 31, 1962, but only with respect to period after that date.

(2) *Certain meal expenses*. Paragraph (h) of this section is effective for expenses paid or incurred after December 31, 1982.

[T.D. 6630, 27 FR 12931, Dec. 29, 1972, as amended by T.D. 7226, 37 FR 26711, Dec. 15, 1972; T.D. 7909, 48 FR 40370, Sept. 7, 1983; 48 FR 41017, Sept. 13, 1983; T.D. 8051, 50 FR 36576, Sept. 9, 1985. Redesignated by T.D. 8715, 62 FR 13990, Mar. 25, 1997; T.D. 8996, 67 FR 35008, May 17, 2002]

TERMINAL RAILROAD CORPORATIONS AND THEIR SHAREHOLDERS

§ 1.281–1 In general.

Section 281 provides special rules for the computation of the taxable incomes of a terminal railroad corporation and its shareholders when the terminal railroad corporation, as a result of taking related terminal income into account, reduces a charge which was made or which would be made for related terminal services furnished to a railroad corporation. Section 281 and paragraphs (a) and (b) of § 1.281–2 provide that the ''reduced amount'' described in paragraph (c) of § 1.281–2 is not includable in gross income of the terminal railroad corporation, is not treated as a dividend or other distribution to its railroad shareholders, and is not treated as an amount paid -or incurred by the railroad shareholders to the terminal railroad corporation. Section 281 and paragraph (a)(2) of § 1.281–2 provide that no deduction otherwise allowable to a terminal railroad corporation shall be disallowed as a result of the ''reduced amount'' described in paragraph (c) of § 1.281–2. Section 1.281–3 defines the terms *terminal railroad corporation*, *related terminal income*, *related terminal services*, *agreement*, and *railroad corporation*. Section 1.281–4 describes the effective dates and special rules for application of section 281 to taxable years ending before October 23, 1962.

[T.D. 7356, 40 FR 23732, June 2, 1975]

§ 1.281–2 Effect of section 281 upon the computation of taxable income.

(a) *Computation of taxable income of terminal railroad corporations*—(1) *Income not considered received or accrued*. A terminal railroad corporation (as defined in paragraph (a) of § 1.281–3) shall not be considered to have received or accrued the ''reduced amount'' described in paragraph (c) of this section in the computation of its taxable income. Thus, income is not to be considered accrued or actually or constructively received by a terminal railroad corporation where, in the manner described in paragraph (c) of this section, (i) a charge which would be made to any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged.

(2) *Deduction not disallowed.* In the computation of the taxable income of a terminal railroad corporation, a deduction relating to a ''reduced amount'', described in paragraph (c) of this section, which is otherwise allowable to it under chapter 1 of the Code (without regard to sec. 277) shall not be disallowed by reason of section 281. Thus, deductions for expenses attributable to services rendered to a shareholder are not to be disallowed to a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to any railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by any railroad corporation with respect to related terminal services is discharged. To the extent that section 281 applies to a deduction relating to a ''reduced amount'', such deduction shall not be disallowed under section 277.

(b) *Computation of taxable income of shareholders*—(1) *Income not considered received or accrued.* A shareholder of a terminal railroad corporation shall not be considered to have received or accrued any ''reduced amount'' (described in paragraph (c) of this section) in the computation of the shareholder's taxable income. Thus a dividend is not to be considered actually or constructively received by a shareholder of a terminal railroad corporation merely because, in the manner described in paragraph (c) of this section, (i) a charge which would be made to the shareholder or any other railroad corporation for related terminal services is not made, or (ii) a portion of any liability payable by it or any other railroad corporation with respect to related terminal services is discharged.

(2) *Expenses not considered paid or incurred.* In the computation of the taxable income of a shareholder of a terminal railroad corporation, the shareholder shall not be considered to have paid or incurred any ''reduced amount'' (described in paragraph (c) of this section). Thus, a shareholder of the terminal railroad corporation may not deduct as an expense for related terminal services (as defined in paragraph (c) of §1.281–3) an amount in excess of the net cost to it of such services.

(c) *Amounts to which section 281 applies*—(1) *Reduced amount.* For purposes of this section, the term *reduced amount* means, subject to the limitation of paragraph (c)(4) of this section, the amount by which:

(i) A charge which would be made by a terminal railroad corporation for its taxable year for related terminal services provided to a railroad corporation; or

(ii) A liability of a railroad corporation, resulting from a charge made by a terminal railroad corporation for its taxable year, with respect to related terminal services provided by the terminal railroad corporation, is reduced by reason of the terminal railroad corporation's taking into account, pursuant to an agreement (as defined in paragraph (d) of §1.281–3), related terminal income (as defined in paragraph (b) of §1.281–3) received or accrued (without regard to section 281) during such taxable year.

(2) *Charge which would be made.* For purposes of this section, a ''charge which would be made'' by a terminal railroad corporation is the amount that would be charged to any railroad corporation for related terminal services provided if the terminal railroad corporation made the charge without taking related terminal income into account.

(3) *Reduction resulting from related terminal income.* For purposes of subparagraph (1) of this section, a charge or a liability is reduced by taking related terminal income into account to the extent that:

(i) Related terminal income is received or accrued (without regard to section 281) by the terminal railroad corporation for its taxable year in which the charge or liability is reduced; and

(ii) The charge or liability in question would have been larger than it is had such income not been received or accrued (without regard to section 281).

The reduction must be made (directly or indirectly) on the books of the terminal railroad corporation, and in fact, for the same taxable year for which the charge would be made or for which the liability is incurred. The reduction of the charge or liability must be taken into account by the terminal railroad corporation in ascertaining the income, profit, or loss for such taxable year for the purpose of reports to shareholders and the Interstate Commerce Commission, and for credit purposes.

(4) *Limitation.* To the extent that a reduced amount (as described in paragraph (c)(1) of this section but without regard to the limitation under this subparagraph) would operate either to create or to increase a net operating loss for the terminal railroad corporation, this section shall not apply. Therefore, if a portion of a liability is discharged (in the manner described in this paragraph) and the discharged portion of the liability exceeds an amount equal to the terminal railroad corporation's gross income minus the deductions allowed by chapter 1 of the Code (computed with regard to the modifications specified in section 172(d) but without regard to section 281 and this section), then section 281 and this section shall not apply to such excess. The limitation described in this subparagraph shall apply only to taxable years of terminal railroad corporations ending after October 23, 1962.

(d) *Examples.* The provisions of this section may be illustrated by the following examples. In these examples, references to ''before the application of section 281'', ''after the application of section 281'', ''taxable income'', and ''allowable deductions'' take no account of section 277, which may apply to deductions to which section 281 does not apply.

Example 1. (i) *Facts.* The T Company is a terminal railroad corporation which charges its three equal shareholders, the X, Y, and Z railroad corporations, a rental calculated monthly on a wheelage or user basis for the use of its services and facilities. The T Company and each of its shareholders report income on the calendar year basis. A written lease agreement to which all of the shareholders were parties was entered into in 1947. The agreement provides that at the end of each year the liabilities of each of the shareholders resulting from charges for rental obligations with respect to related terminal services shall be reduced by the shareholder's one-third share of the net income from each source of revenue that produced income (computed before reduction for Federal income taxes). For the calendar year 1973, the T Company's charges to its shareholders include the following charges for related terminal services: $35,000 to the X Company, $25,000 to the Y Company, and $20,000 to the Z Company. Thus, prior to reduction, total shareholder liabilities to the T Company for related terminal services are $80,000 at the end of 1973. The T Company's net income from all sources (before reduction of liabilities pursuant to the 1947 agreement and before reduction for Federal income taxes) and its taxable income, before the application of section 281, for 1973 are $36,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders	$80,000	$65,000	$15,000
For nonshareholders	46,000	37,000	9,000
Related terminal income	126,000	102,000	24,000
Nonrelated terminal income	30,000	18,000	12,000
Total	156,000	120,000	36,000

The liability of each shareholder is, pursuant to the agreement, discharged in part by the T Company crediting $12,000 against the rental due from each shareholder for a total discharge of liabilities of $36,000 (the net income from all sources), resulting in net shareholder liabilities owing to the T Company at the end of 1973 of $44,000 ($80,000 less $36,000): $23,000 from the X Company, $13,000 from the Y Company, and $8,000 from the Z Company.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is $24,000 (related terminal income of $9,000 from nonshareholders and $15,000 from shareholders). Thus, to the extent of $24,000, the T Company is not considered to have received or accrued income from the discharged liabilities of $36,000. Similarly, to the extent of the same $24,000, the T Company is not disallowed deductions for expenses merely by reason of the discharge. The T Company's taxable income for 1973 after application of section 281 is $12,000, computed as follows:

Gross income ($156,000 less $24,000)	$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders*—The reduced amount of $24,000 shall not be deemed to constitute either a dividend to the shareholders of the T Company or an expense paid or incurred by them. Thus, under the facts described, neither the X Company, the Y Company, nor the Z Company shall be considered to have received or accrued a dividend of $8,000, or to have paid or incurred an expense of $8,000. Assuming the X Company's taxable income for 1973 before the application of section 281 would have been $43,200, computed in the following manner, its taxable income for 1973 after the application of section 281 is $50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than T Co	$146,000	$146,000
Dividend considered received because of T Co.'s discharge of liabilities of $12,000	12,000	4,000
Total	158,000	150,000
Less allowable deductions:		
From sources other than T Co	69,600	69,600
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of T Co.'s discharge of liabilities	10,200	3,400
Expenses for accrued charges for related terminal services performed by T Co	35,000	27,000
	114,800	100,000
Taxable income	43,200	50,000

Example 2. Assume the same facts as in *Example 1*, except that the charges to each of the shareholders for related terminal services for 1973 were as follows: $35,000 to the X Company, $40,000 to the Y Company, and $5,000 to the Z Company. Assume further that the Z Company, prior to the reduction in liabilities at the end of 1973, owed the T Company an additional $4,000 resulting from charges for 1972 for related terminal services and $6,000 resulting from the purchase of equipment. Since only $21,000 (X Company $8,000, Y Company $8,000, Z Company $5,000) of the liabilities which were discharged resulted from charges made for 1973 for related terminal services, the reduced amount to which this section applies is $21,000 (instead of $24,000 as in *Example 1*). Thus, the T Company's taxable income for 1973 would be $15,000 ($36,000 less $21,000 reduced amount) and the amount which shall be considered not to have been received or accrued as a dividend nor paid or incurred as an expense of each shareholder is $8,000 for the X Company, $8,000 for the Y Company, and $5,000 for the Z Company.

Example 3. Assume the same facts as in *Example 1*, except that the allowable deductions with respect to nonrelated terminal activities were $39,000 instead of $18,000. The T Company's net income from all sources (before reduction for Federal income taxes) and its taxable income, before the application of section 281, is therefore $15,000, determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal income	$126,000	$102,000	$24,000
Nonrelated terminal income	30,000	39,000	(9,000)
Total	156,000	141,000	15,000

The liability of each shareholder is nevertheless discharged in part, pursuant to the agreement, by the T Company crediting $8,000 against the rental due from each shareholder for a total discharge of liabilities of $24,000 (the net income from each source of revenue that produced income). Assume further that none of the modifications specified in section 172(d) apply. If the limitation under paragraph (c)(4) of this section were not applied, the reduced amount for the purposes of this section would be $24,000, and the operation of this section would result in a net operating loss of $9,000, since the allowable deductions of $141,000 would exceed the gross income of $132,000 ($156,000 less discharged liabilities of $24,000) by that amount. Because of the limitation under paragraph (c)(4) of this section, however, $9,000 is not included in the reduced amount to which this section applies. Accordingly, the reduced amount is $15,000 (instead of $24,000 as in *Example 1*). Thus, the T Company's taxable income for 1973 would be zero ($15,000 less the $15,000 reduced amount), and the amount which each shareholder shall be considered not to have received or accrued as a dividend nor paid or incurred as an expense is $5,000.

Example 4. Assume the same facts as in *Example 1*, except that under the agreement income from the terminal parking lot would not reduce the shareholders' liabilities. Assume further that such income amounted to $3,000 of the total related terminal income of $24,000 for the taxable year 1973. The liability of each shareholder therefore is discharged by crediting $11,000 against its rental due for a total discharge of liabilities of $33,000. The reduced amount to which this section applies is $21,000 ($24,000 less $3,000) since only to the extent of $21,000 would there have been no such reduction under the agreement if there were no related terminal income.

Example 5. Assume the same facts as in *Example 1,* except that, pursuant to the agreement, the A Company, a nonshareholder railroad corporation, is to have its liabilities resulting from charges for rental obligations reduced equally with each of the shareholders. Assume further that the T Company's charges to the A Company for the calendar year 1973 included $15,000 for related terminal services and that the liability of each shareholder and the A Company is discharged in part pursuant to the agreement by the T Company crediting $9,000 against the rental due from each. The reduced amount to which this section applies is $24,000. Thus, the T Company's taxable income for 1973 is $12,000, and each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense $6,000 ($24,000/ $36,000 × $9,000) merely because of the discharge of its own liability. Similarly, each shareholder shall not be considered to have received or accrued as a dividend nor paid or incurred as an expense $2,000 (1/3 × ($24,000/$36,000 × $9,000)) merely because of the discharge of the liability of the A Company. Section 281 does not apply to the determination of the tax consequences of the transaction to the A Company. Similarly, the section does not apply to the determination of the tax consequences to the shareholders resulting from that portion of the discharge of the liability of the A Company which is attributable to the application of income which is not related terminal income ($3,000). Hence, such consequences shall be determined under the sections of the Internal Revenue Code which govern in the absence of section 281.

Example 6. (i) *Facts.* The TR Company is a terminal railroad corporation with three equal shareholders, the M, N, and O Railroad Corporations. The TR Company and each of its shareholders report income on the calendar year basis. Pursuant to a written agreement entered into in 1947 to which all shareholders were parties, the TR Company makes one annual charge to each of the three shareholders at the end of each year for the difference between the cost of operations, allocated on a wheelage or user basis for the use of its services and facilities provided to the shareholder during the year, and one-third of its net income from all other sources (computed before reduction for Federal income taxes). The TR Company's taxable income, before the application of section 281, for 1973 is $21,000 determined as follows:

Source	Gross income	Allowable deductions	Income (or loss)
Related terminal services performed:			
For shareholders ..	$65,000	$65,000	0
For nonshareholders	46,000	37,000	$9,000
Related terminal income	111,000	102,000	9,000
Nonrelated terminal income from nonshareholders	30,000	18,000	12,000
Total	141,000	120,000	21,000

For the calendar year 1973, the TR company's charges to its shareholders are $23,000 ($30,000 less $7,000) to the M company, $13,000 ($20,000 less $7,000) to the N company, and $8,000 ($15,000 less $7,000) to the O company for a total of $44,000 for related terminal services.

(ii) *Effect on terminal railroad corporation.* The reduced amount to which this section applies is $9,000. The TR company is not considered to have received or accrued income of $9,000 (related terminal income) merely because the charge of $21,000 (net income from all sources other than shareholders) was not made. Similarly, to the extent of $9,000, the TR company is not disallowed deductions for expenses merely because the full cost of services was not charged. The TR company's taxable income for 1973 after application of section 281, is $12,000, computed as follows:

Gross income ($141,000 less $9,000 charges not made)	$132,000
Less allowable deductions	120,000
Taxable income	12,000

(iii) *Effect on shareholders.* Neither the M company, the N company, nor the O company shall be considered to have received or accrued a dividend of $3,000 nor to have paid or incurred an expense of $3,000 merely by reason of the reduced charges. Thus, assuming the M company's taxable income for 1973 before the application of section 281 would have been $47,450, computed in the following manner, its taxable income for 1973 after the application of section 281 is $50,000, determined as follows:

	Before the application of sec. 281	After the application of sec. 281
Gross income:		
From sources other than TR Co	$146,000	$146,000
Dividend considered received because of TR Co.'s reduction of charges	7,000	4,000
Total	153,000	150,000
Less allowable deductions:		
From sources other than TR Co	69,600	69,600

	Before the application of sec. 281	After the application of sec. 281
85 percent dividend received deduction under sec. 243 attributable to dividend considered received because of TR Co.'s reduction of charges	5,950	3,400
Expenses for accrued charges for related terminal services performed by TR Co	30,000	27,000
	105,550	100,000
Taxable income	47,450	50,000

[T.D. 7356, 40 FR 23733, June 2, 1975]

§ 1.281–3 Definitions.

(a) *Terminal railroad corporation.* The term *terminal railroad corporation* means a corporation which, in the taxable year, meets all of the following conditions:

(1) The corporation and each of its shareholders must be domestic corporations. Thus, all of the shareholders of the corporation, as well as the corporation itself, must be corporations which were organized or created in the United States, including only the States and the District of Columbia, or under the law of the United States or of any State or territory.

(2) All of the shareholders must be railroad corporations which are subject to Part I of the Interstate Commerce Act. Thus, if any shareholder of the corporation, regardless of the class or percentage of stock owned, is not subject to the jurisdiction of the Interstate Commerce Commission under part I of that Act, the corporation cannot qualify as a terminal railroad corporation.

(3) The corporation must not be a member of an affiliated group of corporations (as defined in section 1504), other than as a common parent corporation. For this purpose it is immaterial whether or not the affiliated group has ever made a consolidated income tax return. Thus, if the X railroad corporation owns 80 percent of all of the outstanding stock of the Y railroad corporation, the X railroad corporation may qualify, but the Y railroad corporation cannot qualify, as a terminal railroad corporation.

(4) The primary business of the corporation must be that of providing to domestic railroad corporations subject to Part I of the Interstate Commerce Act and to the shippers and passengers of such railroad corporations one or more of the following facilities or services: (i) Railroad terminal facilities, (ii) railroad switching facilities, (iii) railroad terminal services, or (iv) railroad switching services. The designated facilities and services include the furnishing of terminal trackage, the operation of stockyards or a union passenger or freight station, and the operation of railroad bridges and ferries. The providing of the designated facilities includes the leasing of those facilities. A corporation shall be considered as having established that its primary business is that of providing the designated facilities and services if more than 50 percent of its gross income (computed without regard to section 281, and excluding dividends and gains and losses from the disposition of capital assets or property described in section 1231(b)) for the taxable year is derived from those sources. The fact that income from a service or facility is included within the definition of related terminal income is immaterial for purposes of determining whether that service or facility is one which is designated in this subparagraph. Thus, although income from the operation of a commuter railroad line may be related terminal income, a corporation whose primary business is the operation of that facility is not a terminal railroad corporation, since its primary business is not the providing of the designated facilities or services.

(5) A substantial part of the services rendered by the corporation for the taxable year must be rendered to one or more of its shareholders. For purposes of this requirement, providing the use of facilities shall be considered the rendering of services.

(6) Each shareholder of the corporation must compute its taxable income on the basis of a taxable year which either begins or ends on the same day as the taxable year of the corporation.

(b) *Related terminal income*—(1) *In general.* Related terminal income is, generally, the type of income normally earned from the operation of a railroad terminal. The term *related terminal income* means the taxable income (computed without regard to sections 172, 277, or 281) which the terminal railroad corporation derives for the taxable year from the sources enumerated in paragraph (b)(2) of this section. Related terminal income must be derived from direct provision of the specified facilities or services by the terminal corporation itself. Thus, income consisting of rent from a lease of a terminal facility by a terminal corporation to a railroad user would qualify; but dividends from a corporation in which the terminal corporation owned stock and which provided such facilities or services to others would not qualify. The term does not include gain or loss derived from the sale, exchange, or other disposition of capital assets or section 1231 assets, whether or not section 1245 or section 1250 applies to part or all of that gain. For example, the term does not apply to gain from the sale of a terminal building or terminal equipment. All direct and indirect expenses and other deductible items attributable to related terminal services or facilities shall be deducted in determining related terminal income. Attribution shall be determined in accordance with customary railroad accounting practices accepted by the Interstate Commerce Commission, except that interest paid with respect to the indebtedness of a terminal railroad corporation shall be deducted from related terminal income to the extent that the proceeds from the indebtedness were directly or indirectly applied to facilities or activities producing such income. The district director may either accept the use of the taxpayer's method of determining the application of the proceeds of all indebtedness of such corporation or prescribe the use of another method which, under all the facts and circumstances, appears to reflect more accurately the probable application of such proceeds.

(2) *Sources of related terminal income.* The term *related terminal income* includes only income derived from one or more of the following sources:

(i) From services or facilities of a character ordinarily and regularly provided by terminal railroad corporations for railroad corporations or for the employees, passengers, or shippers of railroad corporations. Whether the services or facilities are of a character ordinarily and regularly provided by terminal railroad corporations is to be determined by accepted industry practice. The fact that nonterminal businesses may also provide such services or facilities is immaterial. However, there must be a direct relationship between the service or facility provided and the operation of the terminal, including the operation of its trackage and switching facilities. Thus, the term *related terminal income* includes income derived from operating or leasing switching facilities and terminal facilities, such as income from charges to railroad corporations for the use of a union passenger or freight station. Also included for this purpose is income derived from charges to railroad shippers, including express companies and freight forwarders, for the use of sheds or warehouses, even though not directly intended for railroad use. The term includes income derived from leasing or operating restaurants, drugstores, barbershops, newsstands, ticket agencies, banking facilities, car rental facilities, or other similar facilities for passengers, in waiting rooms or along passenger concourses. Similarly, the term includes income derived from operating or leasing passenger parking facilities, and from renting taxicab space, located on or adjacent to the terminal premises. Although the term does include income derived from the operation of a small hotel operated primarily for and usually occupied primarily by the employees of the railroad corporations, it does not include income derived from the operation of a hotel for passengers or other persons.

(ii) From any railroad corporation for services or facilities provided by the terminal railroad corporation in connection with railroad operations. A service or a facility is provided in connection with railroad operations if it is of a character ordinarily and regularly availed of by railroad corporations. For purposes of this subdivision, the income must be derived from railroad corporations. Thus, in addition to the income derived from sources described in paragraph (b)(2)(i) of this section, the term *related terminal income* includes income derived from switching facilities or leasing to any railroad corporation, or operating for the benefit of such corporation, a beltline or bypass railroad leading to or from the terminal premises. Also included are income derived from the rental of office space (whether or not services are provided to the occupants) in the terminal building to any railroad corporation for that corporation's administrative or operating divisions, and income derived from tolls charged to any railroad corporation for the use of a railroad bridge or ferry.

(iii) From the use by persons other than railroad corporations of a portion of a facility, or of a service, which is used primarily for railroad purposes. A facility or service is used primarily for railroad purposes if the predominant reason for its continued operation or provision is the furnishing of facilities or services described in either subdivision (i) or (ii) of this subparagraph. The determination required by this subdivision is to be made independently for each separate facility or service. Two substantial portions of a single structure may be considered separate facilities, depending upon the respective uses made of each. Moreover, any substantial addition, constructed after October 23, 1962, to a facility shall be considered a separate facility.

The term *related terminal income* includes income produced by operating a commuter service or by renting tracks and facilities for a commuter service to an independent operator. The term also includes the sale or rental of advertising space at a terminal facility. If the conditions described in this subdivision are satisfied, the term *related terminal income* may include income which has no connection with the operation of the terminal. Thus, if a terminal railroad corporation operates a railroad bridge primarily to provide railroad corporations a means of crossing a river and the lower level of the bridge contains a roadway for similar use by automobiles, the term includes income derived from the tolls charged to the automobiles for the use of the bridge roadway. However, upon the discontinuance of operations of the railroad level of the bridge, the term would cease to include the automobile tolls. If excess steam from a steam plant operated primarily to supply steam to the terminal is sold to another business in the neighborhood, the term would include the income derived from such sale. However, because an oil or gas well or a mine constitutes a separate facility, the term *related terminal income* does not include income derived in any form from a deposit of oil, natural gas, or any other mineral located on property owned or leased by the terminal railroad corporation.

Similarly, while the term includes income derived from the rental of a small number of offices located in the terminal building (whether or not the lessees are railroad corporations), it does not include income derived from the leasing or operation, for the use of the general public, of a large number of offices or a large number of rooms for lodging, whether or not the space is physically part of the same structure as the terminal. Moreover, the term does not include income derived from the rental of offices to the general public in an addition to the terminal building constructed after October 23, 1962, unless the addition is primarily used for railroad purposes and the offices rented to the general public do not constitute a separate facility in the addition. Whether or not income from the addition is determined to be related terminal income, the income from the small number of offices which were included in the terminal building before the addition was constructed shall continue to be related terminal income.

(iv) From the United States in payment for facilities or services in connection with mail handling. The income must be derived directly from the U.S. Government, or any agency thereof (including for this purpose the U.S. Postal Service), through the receipt of payments for mail-handling facilities or services. Thus, the term would include income derived from the rental of space for a post office for use by the general public on the terminal premises or from the sorting of mail in a railroad box car.

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

Example. For its calendar year 1973, the R Company, a terminal railroad corporation, has taxable income of $36,000, before the application of section 281 and taking no account of section 277, determined as follows:

Gross income:	
Switching charges	$50,000
Express companies	2,000
Commuter line	4,000
U.S. mail handling	4,000
Railroad bridge tolls:.	
From railroads	2,000
From automobiles	1,000
Total	3,000
Station and train charges	47,000
Terminal parking lot	4,000
Rent from terminal building:	
Passenger facilities (ground level)	8,000
Offices leased to railroads (2d floor)	3,000
Offices leased to others (2d floor)	1,000
Hotel open to public (3d through 6th floors)	14,000
Total	26,000
Interest received from bond investments	1,500
Dividends received from wholly owned subsidiary	10,000
Amount realized from sale of equipment	6,000
Less:	
Adjusted basis	1,000
Expenses of sale	500
	1,500
	4,500
	156,000
Allowable deductions:	
Dividend received deduction	8,500
Interest paid:	
On loan for hotel furnishings	1,500
On loan for rolling stock	2,000
	3,500
Maintenance, depreciation, management and other expenses:	
Attributable to hotel	3,000
Attributable to parking lot	1,000
Attributable to U.S. mail handling	1,000
All other	98,000
	103,000
Loss from sale of securities	3,000
Charitable contribution	500
Net operating loss deduction	1,500
	120,000
Taxable income before the application of sec. 281	36,000
The R Co.'s related terminal income for 1973 is $24,000, computed as follows:	
Taxable income (before the application of sec. 281)	36,000
Less:	
Dividend received	10,000
Minus dividend received deduction	8,500
	1,500
Interest received	1,500
Amount realized from sale of equipment	6,000
Less:	
Adjusted basis	1,000
Expense of sale	500
	1,500
	4,500
Hotel income	14,000
Less:	
Interest paid on loan for hotel	1,500
Other hotel expenses	3,000
	4,500
	9,500
	17,000
	19,000
Add:	
Loss from sale of securities	3,000
Charitable contribution	500
Net operating loss deduction	1,500
	5,000
Related terminal income	24,000

(c) *Related terminal services.* The term *related terminal services* means only the services or the use of facilities, provided by the terminal railroad corporation, which are taken into account in computing related terminal income. Thus, the term includes the providing of terminal and switching services, the furnishing of terminal and switching facilities including the furnishing of terminal trackage, and the operation of bridges and ferries for railroad purposes. For example, upon the facts of the example in the preceding paragraph, the charges for related terminal services are $126,000, determined as follows:

Switching charges	$50,000
Express companies	2,000
Commuter line	4,000
U.S. mail handling	4,000
Railroad bridge tolls	3,000
Station and train charges	47,000
Terminal parking lot	4,000
Rent from:	
Passenger facilities	8,000
Offices	4,000
Total	126,000

(d) *Agreement.* As used in section 281 and §1.281–2 the term *agreement* means a written contract, entered into before the beginning of the terminal railroad corporation's taxable year in question, to which all shareholders of the terminal railroad corporation are parties. The fact that other railroad corporations or persons are also parties will not disqualify an agreement. Section 281 applies only if, and to the extent that, the reduction of the liability or charge that would be made, as described in paragraph (c) of §1.281–2, results from the agreement. Thus, where the other conditions of the statute are met, section 281 applies if a written agreement, to which all of the shareholders were parties and which was entered into prior to the beginning of the terminal railroad corporation's taxable year, provides that the net revenues of the terminal railroad corporation are to be applied as a reduction of what would otherwise be the charge for the taxable year for related terminal services provided to the shareholders. Similarly, section 281 applies, where its other requirements are fulfilled, if the agreement provides that the net revenues are to be credited against rental obligations resulting from related terminal services furnished to shareholders. However, section 281 does not apply where the agreement provides that the net revenues are to be divided among the shareholders and distributed to them in cash or held subject to their unconditional right of withdrawal instead of being applied to the computation of charges, or in reduction of liabilities incurred, for related terminal services.

(e) *Railroad corporation*. For purposes of section 281, §1.281–2, and this section, the term *railroad corporation* means any corporation (regardless of whether it is a shareholder of the terminal railroad corporation) that is engaged as a common carrier in the furnishing or sale of transportation by railroad, or is a lessor of railroad equipment or facilities. For purposes of the preceding sentence, a corporation is a lessor of railroad equipment or facilities only if (1) it is subject to part I of the Interstate Commerce Act, (2) substantially all of its railroad properties have been leased to a railroad corporation or corporations, (3) each lease is for a term of more than 20 years, and (4) 80 percent or more of its gross income for the taxable year is derived for such leases.

[T.D. 7356, 40 FR 23735, June 2, 1975]

§1.281–4 Taxable years affected.

(a) *In general*. Except as provided in paragraph (b) of this section, the provisions of section 281 and §§1.281–2 and 1.281–3 shall apply to all taxable years to which either the Internal Revenue Code of 1954 or the Internal Revenue Code of 1939 apply.

(b) *Taxable years ending before October 23, 1962*. (1)(i) In the case of a taxable year of a terminal railroad corporation ending before October 23, 1962, section 281 (a) shall apply only to the extent that the terminal railroad corporation (*a*) computed its taxable income on its return for such taxable year as if the "reduced amount", described in paragraph (c) of §1.281–2, were not received or accrued, and (*b*) did not decrease its otherwise allowable deductions for such taxable year on account of that "reduced amount". Similarly, in the case of a taxable year of a shareholder of a terminal railroad corporation ending before October 23, 1962, section 281(b) shall apply only to the extent that such shareholder computed its taxable income on its return for such taxable year as if the shareholder had neither received or accrued as a dividend nor paid or incurred as an expense the "reduced amount" described in paragraph (c) of §1.281–2. Such return must have been filed on or before the due date (including the period of any extension of time) for filing the return for the applicable taxable year. The fact that an amended return or claim for refund or credit of overpayment was subsequently filed, or a deficiency subsequently assessed, based upon a computation of taxable income which is inconsistent with the manner in which the taxable income was computed on the timely filed return, is immaterial.

(ii) The provisions of this paragraph may be illustrated by the following examples:

Example 1. The G Company is a terminal railroad corporation which in 1960 reduced the liabilities resulting from charges to its shareholders, pursuant to a 1947 written agreement, by its income from nonshareholder sources. For the calendar year 1960, the G Company's related terminal income was $24,000, of which $3,000 is attributable to income from the United States in payment for facilities and services in connection with mail handling. Although the shareholders' liabilities were reduced by $24,000 as a result of taking related terminal income earned during the taxable year into account, on its timely filed 1960 income tax return the G Company treated the $3,000 of liabilities which were reduced on account of income from mail handling as gross income received or accrued during the year. Assuming that the provisions of §1.281–2 otherwise apply, their application to the determination of the 1960 tax liability of the G Company shall not extend to the entire ''reduced amount'' of $24,000, but shall be limited to $21,000 of that amount.

Example 2. Assume the same facts as in *Example 1*, and the following additional facts. The G Company had three shareholders in 1960, and an equal discharge of liability of $8,000 resulted for each of them on account of related terminal income. Each shareholder treated, on its timely filed 1960 income tax return, $1,000 of its liabilities, which were so reduced and were attributable to income from the United States in payment for facilities and services in connection with mail handling, as if it had received $1,000 from the G Company as a dividend and paid that $1,000 to the G Company for services. Each shareholder treated the remaining $7,000 of its liabilities which were so reduced as if the liabilities which were reduced had never been incurred. Assuming that the provisions of § 1.281–2 otherwise apply, each shareholder shall not be considered to have received or accrued as a dividend, nor to have paid or incurred as an expense $7,000 (instead of $8,000).

(2) For any taxable year of a terminal railroad corporation ending before October 23, 1962, a claim for refund or credit of overpayment of income tax based upon section 281 may be filed, even though such refund or credit of overpayment was otherwise barred by operation of any law or rule of law on October 23, 1962, subject to the conditions set forth in paragraph (b)(2)(i) through (v) of this section.

(i) The claim for refund or credit of overpayment must not have been barred by a closing agreement (under either section 3760 of the Internal Revenue Code of 1939 or section 7121 of the Internal Revenue Code of 1954), or by a compromise (under section 3761 of the Internal Revenue Code of 1939 or section 7122 of the Internal Revenue Code of 1954);

(ii) The claim for refund or credit of overpayment shall be allowed only to the extent that the overpayment of income tax results from the recomputation of the terminal railroad corporation's taxable income in the manner described in paragraph (a) of § 1.281–2;

(iii) The claim for refund or credit of the overpayment must have been filed prior to October 23, 1963;

(iv) The claim for refund or credit of overpayment shall be allowed only to the extent that the manner in which the terminal railroad corporation's taxable income is recomputed is the manner in which the terminal railroad corporation's taxable income was computed on its timely filed income tax return for such taxable year; and

(v) Each railroad corporation which was a shareholder of the terminal railroad corporation during such taxable year must consent in writing to the assessment, within such period as may be agreed upon with the district director, of any deficiency for any year (even though assessment of the deficiency would otherwise be prevented by the operation of any law or rule of law at the time of filing the consent) to the extent that:

(A) The deficiency is attributable to the recomputation of the shareholder's taxable income in the manner described in paragraph (b) of § 1.281–2, and

(B) The deficiency results from the shareholder's allocable portion of the ''reduced amount'' (described in paragraph (c) of § 1.281–2) which gives rise to the refund or credit granted to the terminal railroad corporation under this subparagraph.

[T.D. 7356, 40 FR 23737, June 2, 1975]

§§ 1.282–1.300 [Reserved]

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Table of OMB Control Numbers

The OMB control numbers for chapter I of title 26 were consolidated into §§601.9000 and 602.101 at 50 FR 10221, Mar. 14, 1985. At 61 FR 58008, Nov. 12, 1996, §601.9000 was removed. Section 602.101 is reprinted below for the convenience of the user.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

AUTHORITY: 26 U.S.C. 7805.

§602.101 OMB Control numbers.

(a) *Purpose.* This part collects and displays the control numbers assigned to collections of information in Internal Revenue Service regulations by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1980. The Internal Revenue Service intends that this part comply with the requirements of §§1320.7(f), 1320.12, 1320.13, and 1320.14 of 5 CFR part 1320 (OMB regulations implementing the Paperwork Reduction Act), for the display of control numbers assigned by OMB to collections of information in Internal Revenue Service regulations. This part does not display control numbers assigned by the Office of Management and Budget to collections of information of the Bureau of Alcohol, Tobacco, and Firearms.

(b) *Display.*

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1.170A–2	1545–0074
1.170A–4(A)(b)	1545–0123
1.170A–8	1545–0074
1.170A–9	1545–0052
	1545–0074
1.170A–11	1545–0074
	1545–0123
	1545–1868
1.170A–12	1545–0020
	1545–0074
1.170A–13	1545–0074
	1545–0754
	1545–0908
	1545–1431
1.170A–13(f)	1545–1464
1.170A–14	1545–0763
1.170A–15	1545–1953
1.170A–16	1545–1953
1.170A–17	1545–1953
1.170A–18	1545–1953
1.171–4	1545–1491
1.171–5	1545–1491
1.172–1	1545–0172
1.172–13	1545–0863
1.173–1	1545–0172
1.174–3	1545–0152
1.174–4	1545–0152
1.175–3	1545–0187
1.175–6	1545–0152
1.179–2	1545–1201
1.179–3	1545–1201
1.179–5	1545–0172
	1545–1201
1.179B–1T	1545–2076
1.179C–1	1545–2103
1.179C–1T	1545–2103
1.180–2	1545–0074
1.181–1	1545–2059
1.181–2	1545–2059
1.181–3	1545–2059
1.182–6	1545–0074
1.183–1	1545–0195
1.183–2	1545–0195
1.183–3	1545–0195
1.183–4	1545–0195
1.190–3	1545–0074
1.194–2	1545–0735
1.194–4	1545–0735
1.195–1	1545–1582
1.197–1T	1545–1425
1.197–2	1545–1671
1.199–6	1545–1966
1.213–1	1545–0074
1.215–1T	1545–0074
1.217–2	1545–0182
1.243–3	1545–0123
1.243–4	1545–0123
1.243–5	1545–0123
1.248–1	1545–0172
1.261–1	1545–1041
1.263(a)–1	1545–2248
1.263(a)–3	1545–2248
1.263(a)–5	1545–1870
1.263(e)–1	1545–0123
1.263A–1	1545–0987
1.263A–1T	1545–0187

CFR part or section where identified and described	Current OMB control No.
1.263A–2	1545–0987
1.263A–3	1545–0987
1.263A–8(b)(2)(iii)	1545–1265
1.263A–9(d)(1)	1545–1265
1.263A–9(f)(1)(ii)	1545–1265
1.263A–9(f)(2)(iv)	1545–1265
1.263A–9(g)(2)(iv)(C)	1545–1265
1.263A–9(g)(3)(iv)	1545–1265
1.265–1	1545–0074
1.265–2	1545–0123
1.266–1	1545–0123
1.267(f)–1	1545–0885
1.268–1	1545–0184
1.274–1	1545–0139
1.274–2	1545–0139
1.274–3	1545–0139
1.274–4	1545–0139
1.274–5	1545–0771
1.274–5A	1545–0139
	1545–0771
1.274–5T	1545–0074
	1545–0172
	1545–0771
1.274–6	1545–0139
	1545–0771
1.274–6T	1545–0074
	1545–0771
1.274–7	1545–0139
1.274–8	1545–0139
1.279–6	1545–0123
1.280C–4	1545–1155
1.280F–3T	1545–0074
1.280G–1	1545–1851
1.281–4	1545–0123
1.302–4	1545–0074
1.305–3	1545–0123
1.305–5	1545–1438
1.307–2	1545–0074
1.312–15	1545–0172
1.316–1	1545–0123
1.331–1	1545–0074
1.332–4	1545–0123
1.332–6	1545–2019
1.336–2	1545–2125
1.336–4	1545–2125
1.337(d)–1	1545–1160
1.337(d)–2	1545–1160
	1545–1774
1.337(d)–4	1545–1633
1.337(d)–5	1545–1672
1.337(d)–6	1545–1672
1.337(d)–7	1545–1672
1.338–2	1545–1658
1.338–5	1545–1658
1.338–10	1545–1658
1.338–11	1545–1990
1.338(h)(10)–1	1545–1658
1.338(i)–1	1545–1990
1.351–3	1545–2019
1.355–5	1545–2019
1.362–2	1545–0123
1.362–4	1545–2247
1.367(a)–1T	1545–0026
1.367(a)–2T	1545–0026
1.367(a)–3	1545–0026
	1545–1478
1.367(a)–3T	1545–2183
1.367(a)–6T	1545–0026
1.367(a)–7	1545–2183
1.367(a)–7T	1545–2183
1.367(a)–8	1545–1271
	1545–2056

CFR part or section where identified and described	Current OMB control No.
	1545–2183
1.367(b)–1	1545–1271
1.367(b)–3T	1545–1666
1.367(d)–1T	1545–0026
1.367(e)–1	1545–1487
1.367(e)–2	1545–1487
1.368–1	1545–1691
1.368–3	1545–2019
1.371–1	1545–0123
1.371–2	1545–0123
1.374–3	1545–0123
1.381(b)–1	1545–0123
1.381(c)(4)–1	1545–0123
	1545–0152
	1545–0879
1.381(c)(5)–1	1545–0123
	1545–0152
1.381(c)(6)–1	1545–0123
	1545–0152
1.381(c)(8)–1	1545–0123
1.381(c)(10)–1	1545–0123
1.381(c)(11)–1(k)	1545–0123
1.381(c)(13)–1	1545–0123
1.381(c)(17)–1	1545–0045
1.381(c)(22)–1	1545–1990
1.381(c)(25)–1	1545–0045
1.382–1T	1545–0123
1.382–2	1545–0123
1.382–2T	1545–0123
1.382–3	1545–1281
	1545–1345
1.382–4	1545–1120
1.382–6	1545–1381
1.382–8	1545–1434
1.382–9	1545–1120
	1545–1260
	1545–1275
	1545–1324
1.382–11	1545–2019
1.382–91	1545–1260
	1545–1324
1.383–1	1545–0074
	1545–1120
1.401–1	1545–0020
	1545–0197
	1545–0200
	1545–0534
	1545–0710
1.401(a)–11	1545–0710
1.401(a)–20	1545–0928
1.401(a)–31	1545–1341
1.401(a)–50	1545–0710
1.401(a)(9)–1	1545–1573
1.401(a)(9)–3	1545–1466
1.401(a)(9)–4	1545–1573
1.401(a)(9)–6	1545–2234
1.401(a)(31)–1	1545–1341
1.401(b)–1	1545–0197
1.401(f)–1	1545–0710
1.401(k)–1	1545–1039
	1545–1069
	1545–1669
	1545–1930
1.401(k)–2	1545–1669
1.401(k)–3	1545–1669
1.401(k)–4	1545–1669
1.401(m)–3	1545–1699
1.401–14	1545–0710
1.402(c)–2	1545–1341
1.402(f)–1	1545–1341
	1545-1632
1.402A–1	1545–1992

CFR part or section where identified and described	Current OMB control No.
1.403(b)–1	1545–0710
1.403(b)–3	1545–0996
1.403(b)–7	1545–1341
1.403(b)–10	1545–2068
1.404(a)–12	1545–0710
1.404A–2	1545–0123
1.404A–6	1545–0123
1.408–2	1545–0390
1.408–5	1545–0747
1.408–6	1545–0203
	1545–0390
1.408–7	1545–0119
1.408(q)–1	1545–1841
1.408A–2	1545–1616
1.408A–4	1545–1616
1.408A–5	1545–1616
1.408A–7	1545–1616
1.410(a)–2	1545–0710
1.410(d)–1	1545–0710
1.411(a)–11	1545–1471
	1545–1632
1.411(d)–4	1545–1545
1.411(d)–6	1545–1477
1.412(c)(1)–2	1545–0710
1.412(c)(2)–1	1545–0710
1.412(c)(3)–2	1545–0710
1.414(c)–5	1545–0797
1.414(r)–1	1545–1221
1.415–2	1545–0710
1.415–6	1545–0710
1.417(a)(3)–1	1545–0928
1.417(e)–1	1545–1471
	1545–1724
1.417(e)–1T	1545–1471
1.419A(f)(6)–1	1545–1795
1.422–1	1545–0820
1.430(f)–1	1545–2095
1.430(g)–1	1545–2095
1.430(h)(2)–1	1545–2095
1.432(e)(9)–1T	1545–2260
1.436–1	1545–2095
1.441–2	1545–1748
1.442–1	1545–0074
	1545–0123
	1545–0134
	1545–0152
	1545–0820
	1545–1748
1.443–1	1545–0123
1.444–3T	1545–1036
1.444–4	1545–1591
1.446–1	1545–0074
	1545–0152
1.446–4(d)	1545–1412
1.448–1(g)	1545–0152
1.448–1(h)	1545–0152
1.448–1(i)	1545–0152
1.448–2	1545–1855
1.448–2T	1545–0152
	1545–1855
1.451–1	1545–0091
1.451–4	1545–0123
1.451–6	1545–0074
1.451–7	1545–0074
1.453–1	1545–0152
1.453–2	1545–0152
1.453–8	1545–0152
	1545–0228
1.453A–1	1545–0152
	1545–1134
1.453A–3	1545–0963
1.454–1	1545–0074

CFR part or section where identified and described	Current OMB control No.
1.455–2	1545–0152
1.455–6	1545–0123
1.456–2	1545–0123
1.456–6	1545–0123
1.456–7	1545–0123
1.457–8	1545–1580
1.458–1	1545–0879
1.458–2	1545–0152
1.460–1	1545–1650
1.460–6	1545–1031
	1545–1572
	1545–1732
1.461–1	1545–0074
1.461–2	1545–0096
1.461–4	1545–0917
1.461–5	1545–0917
1.463–1T	1545–0916
1.465–1T	1545–0712
1.466–1T	1545–0152
1.466–4	1545–0152
1.468A–3	1545–1269
	1545–1378
	1545–1511
1.468A–3(h), 1.468A–7, and 1.468A–8(d)	1545–2091
1.468A–4	1545–0954
1.468A–7	1545–0954
	1545–1511
1.468A–8	1545–1269
1.468B–1	1545–1631
1.468B–1(j)	1545–1299
1.468B–2(k)	1545–1299
1.468B–2(l)	1545–1299
1.468B–3(b)	1545–1299
1.468B–3(e)	1545–1299
1.468B–5(b)	1545–1299
1.468B–9	1545–1631
1.469–1	1545–1008
1.469–2T	1545–0712
	1545–1091
1.469–4T	1545–0985
	1545–1037
1.469–7	1545–1244
1.471–2	1545–0123
1.471–5	1545–0123
1.471–6	1545–0123
1.471–8	1545–0123
1.471–11	1545–0123
	1545–0152
1.472–1	1545–0042
	1545–0152
1.472–2	1545–0152
1.472–3	1545–0042
1.472–5	1545–0152
1.472–8	1545–0028
	1545–0042
	1545–1767
1.475(a)–4	1545–1945
1.481–4	1545–0152
1.481–5	1545–0152
1.482–1	1545–1364
1.482–4	1545–1364
1.482–7	1545–1364
	1545–1794
1.482–9(b)	1545–2149
1.501(a)–1	1545–0056
	1545–0057
1.501(c)(3)–1	1545–0056
1.501(c)(9)–5	1545–0047
1.501(c)(17)–3	1545–0047
1.501(e)–1	1545–0814
1.501(r)–3	1545–0047
1.501(r)–4	1545–0047
1.501(r)–6	1545–0047
1.503(c)–1	1545–0047
	1545–0052
1.505(c)–1T	1545–0916
1.506–1	1545–2268
1.507–1	1545–0052
1.507–2	1545–0052
1.508–1	1545–0052
	1545–0056
1.509(a)–3	1545–0047
1.509(a)–4	1545–2157
1.509(a)–5	1545–0047
1.509(c)–1	1545–0052
1.512(a)–1	1545–0687
1.512(a)–4	1545–0047
	1545–0687
1.521–1	1545–0051
	1545–0058
1.527–2	1545–0129
1.527–5	1545–0129
1.527–6	1545–0129
1.527–9	1545–0129
1.528–8	1545–0127
1.529A–2	1545–2293
1.529A–5	1545–2262
1.529A–6	1545–2262
1.529A–7	1545–2262
1.533–2	1545–0123
1.534–2	1545–0123
1.542–3	1545–0123
1.545–2	1545–0123
1.545–3	1545–0123
1.547–2	1545–0045
	1545–0123
1.547–3	1545–0123
1.561–1	1545–0044
1.561–2	1545–0123
1.562–3	1545–0123
1.563–2	1545–0123
1.564–1	1545–0123
1.565–1	1545–0043
	1545–0123
1.565–2	1545–0043
1.565–3	1545–0043
1.565–5	1545–0043
1.565–6	1545–0043
1.585–1	1545–0123
1.585–3	1545–0123
1.585–8	1545–1290
1.597–2	1545–1300
1.597–4	1545–1300
1.597–6	1545–1300
1.597–7	1545–1300
1.611–2	1545–0099
1.611–3	1545–0007
	1545–0099
	1545–1784
1.612–4	1545–0074
1.612–5	1545–0099
1.613–3	1545–0099
1.613–4	1545–0099
1.613–6	1545–0099
1.613–7	1545–0099
1.613A–3	1545–0919
1.613A–3(e)	1545–1251
1.613A–3(l)	1545–0919
1.613A–5	1545–0099
1.613A–6	1545–0099
1.614–2	1545–0099
1.614–3	1545–0099
1.614–5	1545–0099
1.614–6	1545–0099

CFR part or section where identified and described	Current OMB control No.
1.614–8	1545–0099
1.617–1	1545–0099
1.617–3	1545–0099
1.617–4	1545–0099
1.631–1	1545–0007
1.631–2	1545–0007
1.641(b)–2	1545–0092
1.642(c)–1	1545–0092
1.642(c)–2	1545–0092
1.642(c)–5	1545–0074
1.642(c)–6	1545–0020
	1545–0074
	1545–0092
1.642(g)–1	1545–0092
1.642(i)–1	1545–0092
1.645–1	1545–1578
1.663(b)–2	1545–0092
1.664–1	1545–0196
1.664–1(a)(7)	1545–1536
1.664–1(c)	1545–2101
1.664–2	1545–0196
1.664–3	1545–0196
1.664–4	1545–0020
	1545–0196
1.665(a)–0A through 1.665(g)–2A	1545–0192
1.666(d)–1A	1545–0092
1.671–4	1545–1442
1.671–5	1545–1540
1.701–1	1545–0099
1.702–1	1545–0074
1.703–1	1545–0099
1.704–2	1545–1090
1.706–1	1545–0074
	1545–0099
	1545–0134
1.706–1T	1545–0099
1.706–4(f)	1545–0123
1.707–3(c)(2)	1545–1243
1.707–5(a)(7)(ii)	1545–1243
1.707–6(c)	1545–1243
1.707–8	1545–1243
1.708–1	1545–0099
1.732–1	1545–0099
	1545–1588
1.736–1	1545–0074
1.743–1	1545–0074
	1545–1588
1.751–1	1545–0074
	1545–0099
	1545–0941
1.752–2	1545–1905
1.752–5	1545–1090
1.752–7	1545–1843
1.754–1	1545–0099
1.755–1	1545–0099
1.761–2	1545–1338
1.801–1	1545–0123
	1545–0128
1.801–3	1545–0123
1.801–5	1545–0128
1.801–8	1545–0128
1.804–4	1545–0128
1.811–2	1545–0128
1.812–2	1545–0128
1.815–6	1545–0128
1.818–4	1545–0128
1.818–5	1545–0128
1.818–8	1545–0128
1.819–2	1545–0128
1.822–5	1545–1027
1.822–6	1545–1027
1.822–8	1545–1027
1.822–9	1545–1027
1.826–1	1545–1027
1.826–2	1545–1027
1.826–3	1545–1027
1.826–4	1545–1027
1.826–6	1545–1027
1.831–3	1545–0123
1.832–4	1545–1227
1.832–5	1545–0123
1.848–2(g)(8)	1545–1287
1.848–2(h)(3)	1545–1287
1.848–2(i)(4)	1545–1287
1.851–2	1545–1010
1.851–4	1545–0123
1.852–1	1545–0123
1.852–4	1545–0123
	1545–0145
1.852–6	1545–0123
	1545–0144
1.852–7	1545–0074
1.852–9	1545–0074
	1545–0123
	1545–0144
	1545–0145
	1545–1783
1.852–11	1545–1094
1.853–3	1545–2035
1.853–4	1545–2035
1.854–2	1545–0123
1.855–1	1545–0123
1.856–2	1545–0123
	1545–1004
1.856–6	1545–0123
1.856–7	1545–0123
1.856–8	1545–0123
1.857–8	1545–0123
1.857–9	1545–0074
1.858–1	1545–0123
1.860–2	1545–0045
1.860–4	1545–0045
	1545–1054
	1545–1057
1.860E–1	1545–1675
1.860E–2(a)(5)	1545–1276
1.860E–2(a)(7)	1545–1276
1.860E–2(b)(2)	1545–1276
1.860G–2	1545–2110
1.861–2	1545–0089
1.861–3	1545–0089
1.861–4	1545–1900
1.861–8	1545–0126
1.861–8(e)(6) and (g)	1545–1224
1.861–9T	1545–0121
	1545–1072
1.861–18	1545–1594
1.863–1	1545–1476
1.863–3	1545–1476
	1545–1556
1.863–3A	1545–0126
1.863–4	1545–0126
1.863–7	1545–0132
1.863–8	1545–1718
1.863–9	1545–1718
1.864–4	1545–0126
1.871–1	1545–0096
1.871–6	1545–0795
1.871–7	1545–0089
1.871–10	1545–0089
	1545–0165
1.874–1	1545–0089
1.881–4	1545–1440

CFR part or section where identified and described	Current OMB control No.
1.882–4	1545–0126
1.883–0	1545–1677
1.883–1	1545–1677
1.883–2	1545–1677
1.883–3	1545–1677
1.883–4	1545–1677
1.883–5	1545–1677
1.884–0	1545–1070
1.884–1	1545–1070
1.884–2	1545–1070
1.884–2T	1545–0126
	1545–1070
1.884–4	1545–1070
1.884–5	1545–1070
1.892–1T	1545–1053
1.892–2T	1545–1053
1.892–3T	1545–1053
1.892–4T	1545–1053
1.892–5T	1545–1053
1.892–6T	1545–1053
1.892–7T	1545–1053
1.897–2	1545–0123
	1545–0902
1.897–3	1545–0123
1.897–5T	1545–0902
1.897–6T	1545–0902
1.901–2	1545–0746
1.901–2A	1545–0746
1.901–3	1545–0122
1.902–1	1545–0122
	1545–1458
1.904–1	1545–0121
	1545–0122
1.904–2	1545–0121
	1545–0122
1.904–3	1545–0121
1.904–4	1545–0121
1.904–5	1545–0121
1.904–7	1545–2104
1.904–7T	1545–2104
1.904(f)–1	1545–0121
	1545–0122
1.904(f)–2	1545–0121
1.904(f)–3	1545–0121
1.904(f)–4	1545–0121
1.904(f)–5	1545–0121
1.904(f)–6	1545–0121
1.904(f)–7	1545–1127
1.905–2	1545–0122
1.905–3T	1545–1056
1.905–4T	1545–1056
1.905–5T	1545–1056
1.911–1	1545–0067
	1545–0070
1.911–2	1545–0067
	1545–0070
1.911–3	1545–0067
	1545–0070
1.911–4	1545–0067
	1545–0070
1.911–5	1545–0067
	1545–0070
1.911–6	1545–0067
	1545–0070
1.911–7	1545–0067
	1545–0070
1.913–13	1545–0067
1.921–1T	1545–0190
	1545–0884
	1545–0935
	1545–0939
1.921–2	1545–0884
1.927(a)–1T	1545–0935
1.927(d)–2T	1545–0935
1.931–1	1545–0074
	1545–0123
1.934–1	1545–0782
1.935–1	1545–0074
	1545–0087
	1545–0803
1.936–1	1545–0215
	1545–0217
1.936–4	1545–0215
1.936–5	1545–0704
1.936–6	1545–0215
1.936–7	1545–0215
1.936–10(c)	1545–1138
1.937–1	1545–1930
1.952–2	1545–0126
1.953–2	1545–0126
1.954–1	1545–1068
1.954–2	1545–1068
1.955–2	1545–0123
1.955–3	1545–0123
1.955A–2	1545–0755
1.955A–3	1545–0755
1.956–1	1545–0704
1.956–2	1545–0704
1.959–1	1545–0704
1.959–2	1545–0704
1.960–1	1545–0122
1.962–2	1545–0704
1.962–3	1545–0704
1.964–1	1545–0126
	1545–0704
	1545–1072
	1545–2104
1.964–3	1545–0126
1.970–2	1545–0126
1.985–2	1545–1051
	1545–1131
1.985–3	1545–1051
1.987–1	1545–2265
1.987–3	1545–2265
1.987–9	1545–2265
1.987–10	1545–2265
1.988–0	1545–1131
1.988–1	1545–1131
1.988–2	1545–1131
1.988–3	1545–1131
1.988–4	1545–1131
1.988–5	1545–1131
1.988–6	1545–1831
1.992–1	1545–0190
	1545–0938
1.992–2	1545–0190
	1545–0884
	1545–0938
1.992–3	1545–0190
	1545–0938
1.992–4	1545–0190
	1545–0938
1.993–3	1545–0938
1.993–4	1545–0938
1.994–1	1545–0938
1.995–5	1545–0938
1.1001–1	1545–1902
1.1012–1	1545–0074
	1545–1139
1.1014–4	1545–0184
1.1015–1	1545–0020
1.1017–1	1545–1539
1.1031(d)–1T	1545–1021
1.1033(a)–2	1545–0184

CFR part or section where identified and described	Current OMB control No.
1.1033(g)–1	1545–0184
1.1039–1	1545–0184
1.1041–1T	1545–0074
1.1041–2	1545–1751
1.1042–1T	1545–0916
1.1044(a)–1	1545–1421
1.1045–1	1545–1893
1.1060–1	1545–1658
	1545–1990
1.1071–1	1545–0184
1.1071–4	1545–0184
1.1081–4	1545–0028
	1545–0046
	1545–0123
1.1081–11	1545–2019
1.1082–1	1545–0046
1.1082–2	1545–0046
1.1082–3	1545–0046
	1545–0184
1.1082–4	1545–0046
1.1082–5	1545–0046
1.1082–6	1545–0046
1.1083–1	1545–0123
1.1092(b)–1T	1545–0644
1.1092(b)–2T	1545–0644
1.1092(b)–3T	1545–0644
1.1092(b)–4T	1545–0644
1.1092(b)–5T	1545–0644
1.1211–1	1545–0074
1.1212–1	1545–0074
1.1221–2	1545–1480
1.1231–1	1545–0177
	1545–0184
1.1231–2	1545–0177
	1545–0184
1.1231–2	1545–0074
1.1232–3	1545–0074
1.1237–1	1545–0184
1.1239–1	1545–0091
1.1242–1	1545–0184
1.1243–1	1545–0123
1.1244(e)–1	1545–0123
	1545–1447
1.1245–1	1545–0184
1.1245–2	1545–0184
1.1245–3	1545–0184
1.1245–4	1545–0184
1.1245–5	1545–0184
1.1245–6	1545–0184
1.1248–7	1545–0074
1.1248(f)–2	1545–2183
1.1248(f)–3T	1545–2183
1.1250–1	1545–0184
1.1250–2	1545–0184
1.1250–3	1545–0184
1.1250–4	1545–0184
1.1250–5	1545–0184
1.1251–1	1545–0184
1.1251–2	1545–0074
	1545–0184
1.1251–3	1545–0184
1.1251–4	1545–0184
1.1252–1	1545–0184
1.1252–2	1545–0184
1.1254–1(c)(3)	1545–1352
1.1254–4	1545–1493
1.1254–5(d)(2)	1545–1352
1.1258–1	1545–1452
1.1272–3	1545–1353
1.1273–2(f)(9)	1545–1353
1.1273–2(h)(2)	1545–1353
1.1274–3(d)	1545–1353
1.1274–5(b)	1545–1353
1.1274A–1(c)	1545–1353
1.1275–2	1545–1450
1.1275–3	1545–0887
	1545–1353
	1545–1450
1.1275–4	1545–1450
1.1275–6	1545–1450
1.1287–1	1545–0786
1.1291–9	1545–1507
1.1291–10	1545–1304
	1545–1507
1.1294–1T	1545–1002
	1545–1028
1.1295–1	1545–1555
1.1295–3	1545–1555
1.1298–3	1545–1507
1.1301–1	1545–1662
1.1311(a)–1	1545–0074
1.1361–1	1545–0731
	1545–1591
	1545–2114
1.1361–3	1545–1590
1.1361–5	1545–1590
1.1362–1	1545–1308
1.1362–2	1545–1308
1.1362–3	1545–1308
1.1362–4	1545–1308
1.1362–5	1545–1308
1.1362–6	1545–1308
1.1362–7	1545–1308
1.1362–8	1545–1590
1.1363–2	1545–1906
1.1366–1	1545–1613
1.1367–1(f)	1545–1139
1.1368–1(f)(2)	1545–1139
1.1368–1(f)(3)	1545–1139
1.1368–1(f)(4)	1545–1139
1.1368–1(g)(2)	1545–1139
1.1374–1A	1545–0130
1.1377–1	1545–1462
1.1378–1	1545–1748
1.1383–1	1545–0074
1.1385–1	1545–0074
	1545–0098
1.1388–1	1545–0118
	1545–0123
1.1397E–1	1545–1908
1.1398–1	1545–1375
1.1398–2	1545–1375
1.1402(a)–2	1545–0074
1.1402(a)–5	1545–0074
1.1402(a)–11	1545–0074
1.1402(a)–15	1545–0074
1.1402(a)–16	1545–0074
1.1402(b)–1	1545–0171
1.1402(c)–2	1545–0074
1.1402(e)(1)–1	1545–0074
1.1402(e)(2)–1	1545–0074
1.1402(e)–1A	1545–0168
1.1402(e)–2A	1545–0168
1.1402(e)–3A	1545–0168
1.1402(e)–4A	1545–0168
1.1402(e)–5A	1545–0168
1.1402(f)–1	1545–0074
1.1402(h)–1	1545–0064
1.1411–10(g)	1545–2227
1.1441–1	1545–1484
1.1441–2	1545–0795
1.1441–3	1545–0165
	1545–0795
1.1441–4	1545–1484

CFR part or section where identified and described	Current OMB control No.
1.1441–5	1545–0096
	1545–0795
	1545–1484
1.1441–6	1545–0055
	1545–0795
	1545–1484
1.1441–7	1545–0795
1.1441–8	1545–1053
	1545–1484
1.1441–9	1545–1484
1.1443–1	1545–0096
1.1445–1	1545–0902
1.1445–2	1545–0902
	1545–1060
	1545–1797
1.1445–3	1545–0902
	1545–1060
	1545–1797
1.1445–4	1545–0902
1.1445–5	1545–0902
1.1445–6	1545–0902
	1545–1060
1.1445–7	1545–0902
1.1445–8	1545–0096
1.1445–9T	1545–0902
1.1445–10T	1545–0902
1.1446–1	1545–1934
1.1446–3	1545–1934
1.1446–4	1545–1934
1.1446–5	1545–1934
1.1446–6	1545–1934
1.1451–1	1545–0054
1.1451–2	1545–0054
1.1461–1	1545–0054
	1545–0055
	1545–0795
	1545–1484
1.1461–2	1545–0054
	1545–0055
	1545–0096
	1545–0795
1.1462–1	1545–0795
1.1502–5	1545–0257
1.1502–9	1545–1634
1.1502–13	1545–0123
	1545–0885
	1545–1161
	1545–1433
1.1502–16	1545–0123
1.1502–19	1545–0123
	1545–1774
1.1502–20	1545–1774
1.1502–21	1545–0123
1.1502–31	1545–1344
1.1502–32	1545–1344
	1545–1774
1.1502–33	1545–1344
1.1502–35	1545–1828
1.1502–36	1545–2096
1.1502–47	1545–0123
1.1502–75	1545–0025
	1545–0123
	1545–0133
	1545–0152
1.1502–76	1545–1344
1.1502–77	1545–1699
1.1502–77A	1545–0123
	1545–1046
1.1502–77B	1545–1699
1.1502–78	1545–0582
1.1502–95	1545–1218
1.1502–96	1545–1218

CFR part or section where identified and described	Current OMB control No.
1.1503(d)–1	1545–1946
1.1503(d)–3	1545–1946
1.1503(d)–4	1545–1946
1.1503(d)–5	1545–1946
1.1503(d)–6	1545–1946
1.1552–1	1545–0123
1.1561–3	1545–0123
1.1563–1	1545–0123
	1545–0797
	1545–2019
1.1563–3	1545–0123
1.5000A–3	1545–0074
1.5000A–4	1545–0074
1.5000C–2	1545–0096
	1545–2263
1.5000C–3	1545–0096
	1545–2263
1.5000C–4	1545–1223
	1545–0074
1.6001–1	1545–0058
	1545–0074
	1545–0099
	1545–0123
	1545–0865
1.6011–1	1545–0055
	1545–0074
	1545–0085
	1545–0089
	1545–0090
	1545–0091
	1545–0096
	1545–0121
	1545–0458
	1545–0666
	1545–0675
	1545–0908
1.6011–2	1545–0055
	1545–0938
1.6011–3	1545–0238
	1545–0239
1.6011–4	1545–1685
1.6012–1	1545–0067
	1545–0074
	1545–0085
	1545–0089
	1545–0675
1.6012–2	1545–0047
	1545–0051
	1545–0067
	1545–0123
	1545–0126
	1545–0128
	1545–0130
	1545–0175
	1545–0687
	1545–0890
	1545–1023
	1545–1027
1.6012–3	1545–0047
	1545–0067
	1545–0092
	1545–0196
	1545–0687
1.6012–4	1545–0067
1.6012–5	1545–0067
	1545–0936
	1545–0967
	1545–0970
	1545–0991
	1545–1023
	1545–1033
	1545–1079

CFR part or section where identified and described	Current OMB control No.
1.6012–6	1545–0067
	1545–0089
	1545–0129
1.6013–1	1545–0074
1.6013–2	1545–0091
1.6013–6	1545–0074
1.6013–7	1545–0074
1.6015–5	1545–1719
1.6015(a)–1	1545–0087
1.6015(b)–1	1545–0087
1.6015(d)–1	1545–0087
1.6015(e)–1	1545–0087
1.6015(f)–1	1545–0087
1.6015(g)–1	1545–0087
1.6015(h)–1	1545–0087
1.6015(i)–1	1545–0087
1.6017–1	1545–0074
	1545–0087
	1545–0090
1.6031(a)–1	1545–1583
1.6031(b)–1T	1545–0099
1.6031(c)–1T	1545–0099
1.6032–1	1545–0099
1.6033–2	1545–0047
	1545–0049
	1545–0052
	1545–0092
	1545–0687
	1545–1150
	1545–2117
1.6033–3	1545–0052
1.6034–1	1545–0092
	1545–0094
1.6035–2	1545–0704
1.6037–1	1545–0130
	1545–1023
1.6038–2	1545–1617
	1545–2020
1.6038–3	1545–1617
1.6038A–2	1545–1191
1.6038A–3	1545–1191
	1545–1440
1.6038B–1	1545–1617
	1545–2183
1.6038B–1T	1545–0026
	1545–2183
1.6038B–2	1545–1617
1.6039–2	1545–0820
1.6041–1	1545–0008
	1545–0108
	1545–0112
	1545–0115
	1545–0120
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
	1545–1705
1.6041–2	1545–0008
	1545–0119
	1545–0350
	1545–0441
	1545–1729
1.6041–3	1545–1148
1.6041–4	1545–0115
	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–5	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–6	1545–0008
	1545–0115
1.6041–7	1545–0112
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
1.6042–1	1545–0110
1.6042–2	1545–0110
	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6042–3	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6042–4	1545–0110
1.6043–1	1545–0041
1.6043–2	1545–0041
	1545–0110
	1545–0295
	1545–0387
1.6043–3	1545–0047
1.6044–1	1545–0118
1.6044–2	1545–0118
1.6044–3	1545–0118
1.6044–4	1545–0118
1.6044–5	1545–0118
1.6045–1	1545–0715
	1545–1705
1.6045–1(c)(3)(xi)(C)	1545–2186
1.6045–1(n)(5)	1545–2186
1.6045A–1	1545–2186
1.6045–2	1545–0115
1.6045–4	1545–1085
1.6046–1	1545–0704
	1545–0794
	1545–1317
1.6046–2	1545–0704
1.6046–3	1545–0704
1.6046A	1545–1646
1.6047–1	1545–0119
	1545–0295
	1545–0387
1.6047–2	1545–2234
1.6049–1	1545–0112
	1545–0117
	1545–0295
	1545–0367
	1545–0387
	1545–0597
	1545–0957
1.6049–2	1545–0117
1.6049–3	1545–0117
1.6049–4	1545–0096
	1545–0112
	1545–0117
	1545–1018
	1545–1050
1.6049–5	1545–0096
	1545–0112
	1545–0117
1.6049–6	1545–0096
1.6049–7	1545–1018
1.6050A–1	1545–0115
1.6050B–1	1545–0120

CFR part or section where identified and described	Current OMB control No.
1.6050D–1	1545–0120
	1545–0232
1.6050E–1	1545–0120
1.6050H–1	1545–0901
	1545–1380
1.6050H–2	1545–0901
	1545–1339
	1545–1380
1.6050I–2	1545–1449
1.6050J–1T	1545–0877
1.6050K–1	1545–0941
1.6050S–1	1545–1678
1.6050S–2	1545–1729
1.6050S–3	1545–1678
1.6050S–4	1545–1729
1.6052–1	1545–0008
1.6052–2	1545–0008
1.6055–1	1545–2252
1.6055–2	1545–2252
1.6060–1	1545–0074
1.6060–1(a)(1)	1545–1231
1.6061–1	1545–0123
1.6062–1	1545–0123
1.6063–1	1545–0123
1.6065–1	1545–0123
1.6071–1	1545–0123
	1545–0810
1.6072–1	1545–0074
1.6072–2	1545–0123
	1545–0807
1.6073–1	1545–0087
1.6073–2	1545–0087
1.6073–3	1545–0087
1.6073–4	1545–0087
1.6074–1	1545–0123
1.6074–2	1545–0123
1.6081–1	1545–0066
	1545–0148
	1545–0233
	1545–1057
	1545–1081
1.6081–2	1545–0148
	1545–1036
	1545–1054
1.6081–3	1545–0233
1.6081–4	1545–0188
	1545–1479
1.6081–6	1545–0148
	1545–1054
1.6081–7	1545–0148
	1545–1054
1.6091–3	1545–0089
1.6107–1	1545–0074
	1545–1231
1.6109–1	1545–0074
1.6109–2	1545–2176
1.6115–1	1545–1464
1.6151–1	1545–0074
1.6153–1	1545–0087
1.6153–4	1545–0087
1.6161–1	1545–0087
1.6162–1	1545–0087
1.6164–1	1545–0135
1.6164–2	1545–0135
1.6164–3	1545–0135
1.6164–5	1545–0135
1.6164–6	1545–0135
1.6164–7	1545–0135
1.6164–8	1545–0135
1.6164–9	1545–0135
1.6302–1	1545–0257
1.6302–2	1545–0098
	1545–0257
1.6411–1	1545–0098
	1545–0135
	1545–0582
1.6411–2	1545–0098
	1545–0582
1.6411–3	1545–0098
	1545–0582
1.6411–4	1545–0582
1.6414–1	1545–0096
1.6425–1	1545–0170
1.6425–2	1545–0170
1.6425–3	1545–0170
1.6654–1	1545–0087
	1545–0140
1.6654–2	1545–0087
1.6654–3	1545–0087
1.6655(e)–1	1545–1421
1.6662–3(c)	1545–0889
1.6662–4(e) and (f)	1545–0889
1.6662–6	1545–1426
1.6694–1	1545–0074
1.6694–2	1545–0074
1.6694–2(c)	1545–1231
1.6694–2(c)(3)	1545–1231
1.6694–3(e)	1545–1231
1.6695–1	1545–0074
	1545–1385
1.6696–1	1545–0074
	1545–0240
1.6851–1	1545–0086
	1545–0138
1.6851–2	1545–0086
	1545–0138
1.7476–1	1545–0197
1.7476–2	1545–0197
1.7519–2T	1545–1036
1.7520–1	1545–1343
1.7520–2	1545–1343
1.7520–3	1545–1343
1.7520–4	1545–1343
1.7701(l)–3	1545–1642
1.7872–15	1545–1792
1.9100–1	1545–0074
1.9101–1	1545–0008
2.1–4	1545–0123
2.1–5	1545–0123
2.1–6	1545–0123
2.1–10	1545–0123
2.1–11	1545–0123
2.1–12	1545–0123
2.1–13	1545–0123
2.1–20	1545–0123
2.1–22	1545–0123
2.1–26	1545–0123
3.2	1545–0123
4.954–1	1545–1068
4.954–2	1545–1068
5.6411–1	1545–0042
	1545–0074
	1545–0098
	1545–0129
	1545–0172
	1545–0582
	1545–0619
5c.44F–1	1545–0619
5c.128–1	1545–0123
5c.305–1	1545–0110
5c.442–1	1545–0152
5f.103–1	1545–0720
5f.6045–1	1545–0715
6a.103A–2	1545–0123

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	1545–0720
6a.103A–3	1545–0720
7.465–1	1545–0712
7.465–2	1545–0712
7.465–3	1545–0712
7.465–4	1545–0712
7.465–5	1545–0712
7.936–1	1545–0217
7.999–1	1545–0216
7.6039A–1	1545–0015
7.6041–1	1545–0115
11.410–1	1545–0710
11.412(c)–7	1545–0710
11.412(c)–11	1545–0710
12.7	1545–0190
12.8	1545–0191
12.9	1545–0195
14a.422A–1	1545–0123
15A.453–1	1545–0228
16A.126–2	1545–0074
16A.1255–1	1545–0184
16A.1255–2	1545–0184
18.1371–1	1545–0130
18.1378–1	1545–0130
18.1379–1	1545–0130
18.1379–2	1545–0130
20.2010–2	1545–0015
20.2011–1	1545–0015
20.2014–5	1545–0015
	1545–0260
20.2014–6	1545–0015
20.2016–1	1545–0015
20.2031–2	1545–0015
20.2031–3	1545–0015
20.2031–4	1545–0015
20.2031–6	1545–0015
20.2031–7	1545–0020
20.2031–10	1545–0015
20.2032–1	1545–0015
20.2032A–3	1545–0015
20.2032A–4	1545–0015
20.2032A–8	1545–0015
20.2039–4	1545–0015
20.2051–1	1545–0015
20.2053–3	1545–0015
20.2053–9	1545–0015
20.2053–10	1545–0015
20.2055–1	1545–0015
20.2055–2	1545–0015
	1545–0092
20.2055–3	1545–0015
20.2056(b)–4	1545–0015
20.2056(b)–7	1545–0015
	1545–1612
20.2056A–2	1545–1443
20.2056A–3	1545–1360
20.2056A–4	1545–1360
20.2056A–10	1545–1360
20.2106–1	1545–0015
20.2106–2	1545–0015
20.2204–1	1545–0015
20.2204–2	1545–0015
20.6001–1	1545–0015
20.6011–1	1545–0015
20.6018–1	1545–0015
	1545–0531
20.6018–2	1545–0015
20.6018–3	1545–0015
20.6018–4	1545–0015
	1545–0022
20.6036–2	1545–0015
20.6060–1(a)(1)	1545–1231
20.6061–1	1545–0015
20.6065–1	1545–0015
20.6075–1	1545–0015
20.6081–1	1545–0015
	1545–0181
	1545–1707
20.6091–1	1545–0015
20.6107–1	1545–1231
20.6161–1	1545–0015
	1545–0181
20.6161–2	1545–0015
	1545–0181
20.6163–1	1545–0015
20.6166–1	1545–0181
20.6166A–1	1545–0015
20.6166A–3	1545–0015
20.6324A–1	1545–0754
20.7520–1	1545–1343
20.7520–2	1545–1343
20.7520–3	1545–1343
20.7520–4	1545–1343
22.0	1545–0015
25.2511–2	1545–0020
25.2512–2	1545–0020
25.2512–3	1545–0020
25.2512–5	1545–0020
25.2512–9	1545–0020
25.2513–1	1545–0020
25.2513–2	1545–0020
	1545–0021
25.2513–3	1545–0020
25.2518–2	1545–0959
25.2522(a)–1	1545–0196
25.2522(c)–3	1545–0020
	1545–0196
25.2523(a)–1	1545–0020
	1545–0196
25.2523(f)–1	1545–0015
25.2701–2	1545–1241
25.2701–4	1545–1241
25.2701–5	1545–1273
25.2702–5	1545–1485
25.2702–6	1545–1273
25.6001–1	1545–0020
	1545–0022
25.6011–1	1545–0020
25.6019–1	1545–0020
25.6019–2	1545–0020
25.6019–3	1545–0020
25.6019–4	1545–0020
25.6060–1(a)(1)	1545–1231
25.6061–1	1545–0020
25.6065–1	1545–0020
25.6075–1	1545–0020
25.6081–1	1545–0020
25.6091–1	1545–0020
25.6091–2	1545–0020
25.6107–1	1545–1231
25.6151–1	1545–0020
25.6161–1	1545–0020
25.7520–1	1545–1343
25.7520–2	1545–1343
25.7520–3	1545–1343
25.7520–4	1545–1343
26.2601–1	1545–0985
26.2632–1	1545–0985
	1545–1892
26.2642–1	1545–0985
26.2642–2	1545–0985
26.2642–3	1545–0985
26.2642–4	1545–0985
26.2642–6	1545–1902

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26.2642–7(i)(3) and (4)	1545–2116
26.2652–2	1545–0985
26.2654–1	1545–1902
26.2662–1	1545–0015
	1545–0985
26.2662–2	1545–0985
26.6060–1(a)(1)	1545–1231
26.6107–1	1545–1231
31.3102–3	1545–0029
	1545–0059
	1545–0065
31.3121(b)(19)–1	1545–0029
31.3121(d)–1	1545–0004
31.3121(i)–1	1545–0034
31.3121(r)–1	1545–0029
31.3121(s)–1	1545–0029
31.3121(v)(2)–1	1545–1643
31.3302(a)–2	1545–0028
31.3302(a)–3	1545–0028
31.3302(b)–2	1545–0028
31.3302(e)–1	1545–0028
31.3306(c)(18)–1	1545–0029
31.3401(a)–1	1545–0029
31.3401(a)(6)	1545–1484
31.3401(a)(6)–1	1545–0029
	1545–0096
	1545–0795
31.3401(a)(7)–1	1545–0029
31.3401(a)(8)(A)–1	1545–0029
	1545–0666
31.3401(a)(8)(C)–1	1545–0029
31.3401(a)(15)–1	1545–0182
31.3401(c)–1	1545–0004
31.3402(b)–1	1545–0010
31.3402(c)–1	1545–0010
31.3402(f)(1)–1	1545–0010
31.3402(f)(2)–1	1545–0010
	1545–0410
31.3402(f)(3)–1	1545–0010
31.3402(f)(4)–1	1545–0010
31.3402(f)(4)–2	1545–0010
31.3402(f)(5)–1	1545–0010
	1545–1435
31.3402(h)(1)–1	1545–0029
31.3402(h)(3)–1	1545–0010
	1545–0029
31.3402(h)(4)–1	1545–0010
31.3402(i)–(1)	1545–0010
31.3402(i)–(2)	1545–0010
31.3402(k)–1	1545–0065
31.3402(l)–(1)	1545–0010
31.3402(m)–(1)	1545–0010
31.3402(n)–(1)	1545–0010
31.3402(o)–2	1545–0415
31.3402(o)–3	1545–0008
	1545–0010
	1545–0415
	1545–0717
31.3402(p)–1	1545–0415
	1545–0717
31.3402(q)–1	1545–0238
	1545–0239
31.3404–1	1545–0029
31.3405(c)–1	1545–1341
31.3406(a)–1	1545–0112
31.3406(a)–2	1545–0112
31.3406(a)–3	1545–0112
31.3406(a)–4	1545–0112
31.3406(b)(2)–1	1545–0112
31.3406(b)(2)–2	1545–0112
31.3406(b)(2)–3	1545–0112
31.3406(b)(2)–4	1545–0112
31.3406(b)(2)–5	1545–0112
31.3406(b)(3)–1	1545–0112
31.3406(b)(3)–2	1545–0112
31.3406(b)(3)–3	1545–0112
31.3406(b)(3)–4	1545–0112
31.3406(b)(4)–1	1545–0112
31.3406(c)–1	1545–0112
31.3406(d)–1	1545–0112
31.3406(d)–2	1545–0112
31.3406(d)–3	1545–0112
31.3406(d)–4	1545–0112
31.3406(d)–5	1545–0112
31.3406(e)–1	1545–0112
31.3406(f)–1	1545–0112
31.3406(g)–1	1545–0096
	1545–0112
	1545–1819
31.3406(g)–2	1545–0112
31.3406(g)–3	1545–0112
31.3406(h)–1	1545–0112
31.3406(h)–2	1545–0112
31.3406(h)–3	1545–0112
31.3406(i)–1	1545–0112
31.3501(a)–1T	1545–0771
31.3503–1	1545–0024
31.3504–1	1545–0029
31.3511–1	1545–2266
31.6001–1	1545–0798
31.6001–2	1545–0034
	1545–0798
31.6001–3	1545–0798
31.6001–4	1545–0028
31.6001–5	1545–0798
31.6001–6	1545–0029
	1459–0798
31.6011(a)–1	1545–0029
	1545–0034
	1545–0035
	1545–0059
	1545–0074
	1545–0256
	1545–0718
	1545–2097
31.6011(a)–2	1545–0001
	1545–0002
31.6011(a)–3	1545–0028
31.6011(a)–3A	1545–0955
31.6011(a)–4	1545–0034
	1545–0035
	1545–0718
	1545–1413
	1545–2097
31.6011(a)–5	1545–0028
	1545–0718
	1545–2097
31.6011(a)–6	1545–0028
31.6011(a)–7	1545–0074
31.6011(a)–8	1545–0028
31.6011(a)–9	1545–0028
31.6011(a)–10	1545–0112
31.6011(b)–1	1545–0003
31.6011(b)–2	1545–0029
31.6051–1	1545–0008
	1545–0182
	1545–0458
	1545–1729
31.6051–2	1545–0008
31.6051–3	1545–0008
31.6053–1	1545–0029
	1545–0062
	1545–0064
	1545–0065

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	1545–1603
31.6053–2	1545–0008
31.6053–3	1545–0065
	1545–0714
31.6053–4	1545–0065
	1545–1603
31.6060–1(a)(1)	1545–1231
31.6065(a)–1	1545–0029
31.6071(a)–1	1545–0001
	1545–0028
	1545–0029
31.6071(a)–1A	1545–0955
31.6081(a)–1	1545–0008
	1545–0028
31.6091–1	1545–0028
	1545–0029
31.6107–1	1545–1231
31.6157–1	1545–0955
31.6205–1	1545–0029
	1545–2097
31.6301(c)–1AT	1545–0035
	1545–0112
	1545–0257
31.6302–1	1545–1413
31.6302–2	1545–1413
31.6302–3	1545–1413
31.6302–4	1545–1413
31.6302(c)–2	1545–0001
	1545–0257
31.6302(c)–2A	1545–0955
31.6302(c)–3	1545–0257
31.6402(a)–2	1545–0256
	1545–2097
31.6413(a)–1	1545–0029
	1545–2097
31.6413(a)–2	1545–0029
	1545–0256
	1545–2097
31.6413(c)–1	1545–0029
	1545–0171
31.6414–1	1545–0029
	1545–2097
32.1	1545–0029
	1545–0415
32.2	1545–0029
35a.3406–2	1545–0112
35a.9999–5	1545–0029
36.3121(l)(1)–1	1545–0137
36.3121(l)(1)–2	1545–0137
36.3121(l)(3)–1	1545–0123
36.3121(1)(7)–1	1545–0123
36.3121(1)(10)–1	1545–0029
36.3121(1)(10)–3	1545–0029
36.3121(1)(10)–4	1545–0257
40.6060–1(a)(1)	1545–1231
40.6107–1	1545–1231
40.6302(c)–3(b)(2)(ii)	1545–1296
40.6302(c)–3(b)(2)(iii)	1545–1296
40.6302(c)–3(e)	1545–1296
40.6302(c)–3(f)(2)(ii)	1545–1296
41.4481–1	1545–0143
41.4481–2	1545–0143
41.4483–3	1545–0143
41.6001–1	1545–0143
41.6001–2	1545–0143
41.6001–3	1545–0143
41.6060–1(a)(1)	1545–1231
41.6071(a)–1	1545–0143
41.6081(a)–1	1545–0143
41.6091–1	1545–0143
41.6107–1	1545–1231
41.6109–1	1545–0143

CFR part or section where identified and described	Current OMB control No.
41.6151(a)–1	1545–0143
41.6156–1	1545–0143
41.6161(a)(1)–1	1545–0143
44.4401–1	1545–0235
44.4403–1	1545–0235
44.4412–1	1545–0236
44.4901–1	1545–0236
44.4905–1	1545–0236
44.4905–2	1545–0236
44.6001–1	1545–0235
44.6011(a)–1	1545–0235
	1545–0236
44.6060–1(a)(1)	1545–1231
44.6071–1	1545–0235
44.6091–1	1545–0235
44.6107–1	1545–1231
44.6151–1	1545–0235
44.6419–1	1545–0235
44.6419–2	1545–0235
46.4371–4	1545–0023
46.4374–1	1545–0023
46.4375–1	1545–2238
46.4376–1	1545–2238
46.4701–1	1545–0023
	1545–0257
48.4041–4	1545–0023
48.4041–5	1545–0023
48.4041–6	1545–0023
48.4041–7	1545–0023
48.4041–9	1545–0023
48.4041–10	1545–0023
48.4041–11	1545–0023
48.4041–12	1545–0023
48.4041–13	1545–0023
48.4041–19	1545–0023
48.4041–20	1545–0023
48.4041–21	1545–1270
48.4042–2	1545–0023
48.4052–1	1545–1418
48.4061(a)–1	1545–0023
48.4061(a)–2	1545–0023
48.4061(b)–3	1545–0023
48.4064–1	1545–0014
	1545–0242
48.4071–1	1545–0023
48.4073–1	1545–0023
48.4073–3	1545–0023
	1545–1074
	1545–1087
48.4081–2	1545–1270
	1545–1418
48.4081–3	1545–1270
	1545–1418
	1545–1897
48.4081–4(b)(2)(ii)	1545–1270
48.4081–4(b)(3)(i)	1545–1270
48.4081–4(c)	1545–1270
48.4081–6(c)(1)(ii)	1545–1270
48.4081–7	1545–1270
	1545–1418
48.4082–1T	1545–1418
48.4082–2	1545–1418
48.4082–6	1545–1418
48.4082–7	1545–1418
48.4101–1	1545–1418
48.4101–1T	1545–1418
48.4101–2	1545–1418
48.4161(a)–1	1545–0723
48.4161(a)–2	1545–0723
48.4161(a)–3	1545–0723
48.4161(b)–1	1545–0723
48.4216(a)–2	1545–0023

CFR part or section where identified and described	Current OMB control No.
48.4216(a)–3	1545–0023
48.4216(c)–1	1545–0023
48.4221–1	1545–0023
48.4221–2	1545–0023
48.4221–3	1545–0023
48.4221–4	1545–0023
48.4221–5	1545–0023
48.4221–6	1545–0023
48.4221–7	1545–0023
48.4222(a)–1	1545–0014
	1545–0023
48.4223–1	1545–0023
	1545–0257
	1545–0723
48.6302(c)–1	1545–0023
	1545–0257
48.6412–1	1545–0723
48.6416(a)–1	1545–0023
	1545–0723
48.6416(a)–2	1545–0723
48.6416(a)–3	1545–0723
48.6416(b)(1)–1	1545–0723
48.6416(b)(1)–2	1545–0723
48.6416(b)(1)–3	1545–0723
48.6416(b)(1)–4	1545–0723
48.6416(b)(2)–1	1545–0723
48.6416(b)(2)–2	1545–0723
48.6416(b)(2)–3	1545–0723
	1545–1087
48.6416(b)(2)–4	1545–0723
48.6416(b)(3)–1	1545–0723
48.6416(b)(3)–2	1545–0723
48.6416(b)(3)–3	1545–0723
48.6416(b)(4)–1	1545–0723
48.6416(b)(5)–1	1545–0723
48.6416(c)–1	1545–0723
48.6416(e)–1	1545–0023
	1545–0723
48.6416(f)–1	1545–0023
	1545–0723
48.6416(g)–1	1545–0723
48.6416(h)–1	1545–0723
48.6420(c)–2	1545–0023
48.6420(f)–1	1545–0023
48.6420–1	1545–0162
	1545–0723
48.6420–2	1545–0162
	1545–0723
48.6420–3	1545–0162
	1545–0723
48.6420–4	1545–0162
	1545–0723
48.6420–5	1545–0162
	1545–0723
48.6420–6	1545–0162
	1545–0723
48.6421–0	1545–0162
	1545–0723
48.6421–1	1545–0162
	1545–0723
48.6421–2	1545–0162
	1545–0723
48.6421–3	1545–0162
	1545–0723
48.6421–4	1545–0162
	1545–0723
48.6421–5	1545–0162
	1545–0723
48.6421–6	1545–0162
	1545–0723
48.6421–7	1545–0162
	1545–0723
48.6424–0	1545–0723
48.6424–1	1545–0723
48.6424–2	1545–0723
48.6424–3	1545–0723
48.6424–4	1545–0723
48.6424–5	1545–0723
48.6424–6	1545–0723
48.6427–0	1545–0723
48.6427–1	1545–0023
	1545–0162
	1545–0723
48.6427–2	1545–0162
	1545–0723
48.6427–3	1545–0723
48.6427–4	1545–0723
48.6427–5	1545–0723
48.6427–8	1545–1418
48.6427–9	1545–1418
48.6427–10	1545–1418
48.6427–11	1545–1418
49.4251–1	1545–1075
49.4251–2	1545–1075
49.4251–4(d)(2)	1545–1628
49.4253–3	1545–0023
49.4253–4	1545–0023
49.4264(b)–1	1545–0023
	1545–0224
	1545–0225
	1545–0226
	1545–0230
	1545–0257
	1545–0912
49.4271–1(d)	1545–0685
49.5000B–1	1545–2177
51.2(f)(2)(ii)	1545–2209
51.7	1545–2209
52.4682–1(b)(2)(iii)	1545–1153
52.4682–2(b)	1545–1153
	1545–1361
52.4682–2(d)	1545–1153
	1545–1361
52.4682–3(c)(2)	1545–1153
52.4682–3(g)	1545–1153
52.4682–4(f)	1545–0257
	1545–1153
52.4682–5(d)	1545–1361
52.4682–5(f)	1545–1361
53.4940–1	1545–0052
	1545–0196
53.4942(a)–1	1545–0052
53.4942(a)–2	1545–0052
53.4942(a)–3	1545–0052
53.4942(b)–3	1545–0052
53.4945–1	1545–0052
53.4945–4	1545–0052
53.4945–5	1545–0052
53.4945–6	1545–0052
53.4947–1	1545–0196
53.4947–2	1545–0196
53.4948–1	1545–0052
53.4958–6	1545–1623
53.4961–2	1545–0024
53.4963–1	1545–0024
53.6001–1	1545–0052
53.6011–1	1545–0049
	1545–0052
	1545–0092
	1545–0196
53.6060–1(a)(1)	1545–1231
53.6065–1	1545–0052
53.6071–1	1545–0049
53.6081–1	1545–0066

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	1545–0148
53.6107–1	1545–1231
53.6161–1	1545–0575
54.4975–7	1545–0575
54.4977–1T	1545–0771
54.4980B–6	1545–1581
54.4980B–7	1545–1581
54.4980B–8	1545–1581
54.4980F–1	1545–1780
54.6011–1	1545–0575
54.6011–1T	1545–0575
54.6060–1(a)(1)	1545–1231
54.6107–1	1545–1231
54.9801–3	1545–1537
54.9801–4	1545–1537
54.9801–5	1545–1537
54.9801–6	1545–1537
54.9812–1T	1545–2165
54.9815–1251T	1545–2178
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