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Title 26—Internal Revenue

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

Part

CHAPTER I—Internal Revenue Service, Department of the Treasury (Continued) 1

CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY (CONTINUED)

EDITORIAL NOTE: IRS published a document at 45 FR 6088, Jan. 25, 1980, deleting statutory sections from their regulations. In Chapter I, cross references to the deleted material have been changed to the corresponding sections of the IRS Code of 1954 or to the appropriate regulations sections. When either such change produced a redundancy, the cross reference has been deleted. For further explanation, see 45 FR 20795, March 31, 1980.

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SUPPLEMENTARY PUBLICATIONS: *Internal Revenue Service Looseleaf Regulations System.*

Additional supplementary publications are issued covering *Alcohol and Tobacco Tax Regulations,* and *Regulations Under Tax Conventions.*

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES

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Section 1.263A–7T also issued under 26 U.S.C. 263A.

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Section 1.280F–7 also issued under 26 U.S.C. 280F(c).

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

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COMPUTATION OF TAXABLE INCOME (CONTINUED)

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS (CONTINUED)

§ 1.170–0 Effective dates.

Except as otherwise provided in this section, the provisions of section 170 and §§ 1.170–1 through 1.170–3 are applicable to contributions paid in taxable years beginning before January 1, 1970, and all references therein to sections of the Code are to sections of the Internal Revenue Code of 1954 prior to the amendments made by section 201(a) of the Tax Reform Act of 1969 (83 Stat. 549). Except as otherwise provided therein, §§ 1.170A through 1.170A–11 are applicable to contributions paid in taxable years beginning after December 31, 1969. In a case where a provision in §§ 1.170A through 1.170A–11 is applicable to a contribution paid in a taxable year beginning before January 1, 1970, such provision shall apply to the contribution and §§ 1.170–1 through 1.170–3 shall not apply to the contribution.

[T.D. 7207, 37 FR 20767, Oct. 5, 1972]

§ 1.170–1 Charitable, etc., contributions and gifts; allowance of deduction (before amendment by Tax Reform Act of 1969).

(a) *In general*—(1) *General rule.* Any charitable contribution (as defined in section 170(c)) actually paid during the taxable year is allowable as a deduction in computing taxable income, regardless of the method of accounting employed or when pledged. In addition, contributions by corporations may under certain circumstances be deductible even though not paid during the taxable year (see § 1.170–3), and subject to the provisions of section 170(b)(5) and paragraph (g) of § 1.170–2, certain excess charitable contributions made by individuals in taxable years beginning after December 31, 1963, shall be treated as paid in certain succeeding taxable years. The deduction is subject to the limitations of section 170(b) (see §§ 1.170–2 and 1.170–3) and is subject to verification by the district director. For rules relating to the determination of, and the deduction for, amounts paid to maintain certain students as members of the taxpayer's household and treated under section 170(d) as paid for the use of an organization described in section 170(c) (2), (3), or (4), see paragraph (f) of § 1.170–2. For a special rule relating to the computation of the amount of the deduction with respect to a contribution of section 1245 or section 1250 property, see section 170(e).

(2) *Information required in support of deductions for taxable years beginning before January 1, 1964.* In connection with claims for deductions for charitable contributions paid in taxable years beginning before January 1, 1964, taxpayers shall state in their income tax returns the name and address of each organization to which a contribution was made and the amount and approximate date of the actual payment of each contribution. Any deduction for 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, and the date of its actual payment, and by such other information as the district director may deem necessary.

(3) *Information required in support of deductions for taxable years beginning after December 31, 1963*—(i) *In general.* In connection with claims for deductions for charitable contributions paid in taxable years beginning after December 31, 1963, 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, securities) and shall state the method utilized in determining the fair market value of the property at the time the contribution was made. In any case in which a taxpayer makes numerous cash contributions to an organization during the taxable year, the taxpayer may state the total cash payments made to such organization during the taxable year in lieu of listing each cash contribution and the date of payment.

(ii) *Contribution by individual of property other than money.* 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 a statement setting forth the following information with respect to such item:

(*a*) The name and address of the organization to which the contribution was made.

(*b*) The date of the actual contribution.

(*c*) 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. 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 manner (for example, by purchase, gift, bequest, inheritance, exchange, etc.) and the approximate date of acquisition of the property by the taxpayer. If the property was created, produced, or manufactured by the taxpayer, the approximate date the property was substantially completed.

(*e*) The fair market value of the property at the time the contribution was made, showing the method utilized in determining the fair market value. (If the valuation was determined by appraisal, a copy of the signed report of the appraiser should be submitted.)

(*f*) In the case of property (not including securities) held by the taxpayer for a period less than five years immediately preceding the date on which the contribution was made, the cost or other basis, adjusted as provided by section 1016. If available, the cost or other basis, adjusted as provided by section 1016, of property (not including securities) held for a period of five years or more prior to the time of contribution should be submitted.

(*g*) In the case of section 1245 or section 1250 property, the reduction by reason of section 170(e) in the amount of the charitable contribution taken into account under section 170.

(*h*) The terms of any agreement or understanding entered into by or on behalf of the taxpayer relating to the use, sale, or disposition of the property contributed. For example, there must be attached to the income tax return of an individual taxpayer the terms of any agreement or understanding which restricts the donee's right to dispose of the donated property (either temporarily or permanently) or which reserves to, or confers upon, anyone other than the donee organization (or an organization participating with such organization in cooperative fund raising) 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 who shall have such income, possession, or right to acquire. Notwithstanding the above, it will not be necessary to set forth the terms of any agreement or understanding which merely 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.

(*i*) The total amount claimed as a deduction for the taxable year due to the contribution of the property. 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 the property (if tangible property) is located or kept and the name of the person having actual possession of the property, if other than the organization to which the property giving rise to the deduction was contributed.

(iii) *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 $200 at the time of receipt, such statement shall also indicate for each such item its location if 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 other disposition of the property, the method of disposition.

(b) *Time of making contribution.* Ordinarly a contribution is made at the time delivery is effected. In the case of a check, 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 mailing, provided that such certificate is received in the ordinary course of the mails). If the donor delivers the 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 a contribution consisting of a future interest in tangible personal property, see paragraph (d)(2) of this section.

(c) *Contribution in property*—(1) *General rules.* If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution. 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 lowest 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, unless he sells only at retail in which event it is his retail customers. If a donor makes a charitable contribution of, for example, 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 merchandise contributed would have been sold by the donor at the time of the contribution. Costs and expenses incurred in the year of contribution in producing or acquiring the contributed property are not deductible and are not a part of the cost of goods sold. Similarly, to the extent that costs and expenses incurred in a prior taxable year in producing or acquiring the contributed property are reflected in the cost of goods sold in the year of contribution, cost of goods sold must be reduced by such costs and expenses. Transfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer's business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See section 162 and the regulations thereunder.

(2) *Reduction for certain interest.* (i) With respect to charitable contributions made after December 31, 1957, section 170(b)(4) requires that the amount of the charitable deduction be reduced for certain interest to the extent necessary to avoid the reduction 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 subdivisions (ii) and (iii) of this subparagraph.

(ii) With respect to charitable contributions made after December 31, 1957, 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(b)(4) or this subparagraph 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(b)(4) 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 the contribution is made in property and the transfer is conditioned upon the assumption of a liability by the donee or by some other person, any interest paid (or to be paid) by the taxpayer, attributable to the liability, and with respect to a period after the making of the contribution, will serve to reduce the amount that may be taken into account as a charitable contribution for purposes of section 170. The adjustment referred to in this subdivision 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.

(iii) If, in connection with the charitable contribution, after December 31, 1957, 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(b)(4) or this subparagraph shall, without regard to whether any reduction may be required by subdivision (ii) of this subparagraph, 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 subdivision 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(b)(4) and this subdivision the term *bond* means any bond, debenture, note, or certificate or other evidence of indebtedness.

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

Example 1. A, an individual using the cash receipts and disbursements method of accounting, on January 1, 1960, contributed to a charitable organization real estate having a fair market value of $10,000. In connection with the contribution the charitable organization assumed an indebtedness of $8,000 which A had incurred. A has prepaid two years' interest on that indebtedness (for 1960 and 1961) amounting to $960, and has taken an interest deduction of $960 for such amount. The amount of the gift, determined without regard to this subparagraph, 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 charitable contributions, 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. On January 1, 1960, B, an individual using the cash receipts and disbursements method of accounting, purchased for $9,600 a 5 1/2 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, 1950, at a discount of $720 from the principal amount. On December 1, 1960, 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. During the calendar year 1960 B paid accrued interest of $330 on the indebtedness for the period from January 1 to December 1, 1960, 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 payment of $275. The market value of the bond on the date of the contribution was

$9,902. Such value reflects a proportionate part of the original bond discount ($9,280 plus $393, or $9,673) and of interest receivable of $229 which had accrued from July 1 to December 1, 1960. The amount of the charitable contribution determined without regard to this subparagraph 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 subparagraph 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 eleven-month period B held the bond).

(3) *Reduction for depreciable property.* (i) With respect to a charitable contribution of section 1245 property (as defined in section 1245(a)(3)), or section 1250 property (as defined in section 1250(c)), section 170(e) requires that the amount of the charitable contribution taken into account under section 170 shall be reduced by the amount which would have been treated (but was not actually treated) as gain to which section 1245(a)(1) or 1250(a) (relating to gain from dispositions of depreciable property) applies if the property contributed had been sold at its fair market value (determined at the time of such contribution).

(ii) Section 170(e) applies to charitable contributions of section 1245 property in taxable years beginning after December 31, 1962, except that in respect of section 1245 property which is an elevator or escalator section 170(e) applies to charitable contributions after December 31, 1963. Section 170(e) applies to charitable contributions of section 1250 property after December 31, 1963.

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

Example. Jones contributes to a charitable organization section 1245 property which has an adjusted basis of $10,000, a recomputed basis (as defined in section 1245 (a)(2)) of $14,000, and a fair market value of $17,000. If Jones had instead sold the property at its fair market value, he would have recognized gain under section 1245(a)(1) of $4,000. See paragraph (b) of §1.1245–1. Under section 170(e), the amount of the charitable contribution taken into account under section 170 is reduced by $4,000. Accordingly, the amount of the charitable contribution is $13,000 ($17,000 minus $4,000).

(d) *Transfers of income and future interests*—(1) *In general.* A deduction may be allowed for a contribution of an interest in the income from property or an interest in the remainder (but see subparagraph (2) of this paragraph for rules relating to transfers, after December 31, 1963, of future interests in tangible personal property). The income or remainder interest shall be valued according to the tables referred to in paragraph (d) of §1.170–2. For rules with respect to certain transfers to a trust, see paragraph (d) of §1.170–2.

(2) *Future interests in tangible personal property.* (i) Except as otherwise provided in subdivision (iii) of this subparagraph, a contribution consisting of a transfer, after December 31, 1963, in a taxable year ending after such date, of a future interest in tangible personal property shall be treated as made only when:

(*a*) All intervening interests in, and rights to the actual possession or enjoyment of, the property have expired, or

(*b*) 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).

Section 170(f) and this subparagraph 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 three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. Section 170(f) and this subparagraph 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. For purposes of section 170(f) and this subparagraph, the term *future interest* has generally the same meaning as it has when used in section 2503, relating to taxable gifts, see § 25.2503–3 of Part 25 of this chapter (Gift Tax Regulations), and such term 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.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example 1. On December 31, 1964, 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. 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 as having been made in 1964.

Example 2. Assume the same facts as in *Example 1* except that on December 31, 1965, 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 1965.

Example 3. Assume the same facts as *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, 1965, transfers his interest in the painting to his son, B. 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 as having been made in 1965.

Example 5. Assume the same facts as in *Example 4.* Also assume that on December 31, 1966, B conveys the interest measured by A's life to the museum. B has made a charitable contribution of the present interest in the painting conveyed to the museum (i.e., the life interest measured by A's life expectancy in 1966 valued according to paragraph (f), Table 1, of § 20.2031–7 of Part 20 of this chapter (Estate Tax Regulations)). 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 1966. Such remainder interest shall also be valued according to paragraph (f), Table 1, of § 20.2031–7 of Part 20 of this chapter (Estate Tax Regulations)).

(iii) Section 209(f)(3) of the Revenue Act of 1964 (78 Stat. 47) provides an exception to the rule set forth in section 170(f). Pursuant to the exception, section 170(f) and subdivision (i) of this subparagraph shall not apply in the case of a transfer of a future interest in tangible personal property made after December 31, 1963, and before July 1, 1964, where:

(*a*) The sole intervening interest or right is a nontransferable life interest reserved by the donor, or

(*b*) In the case of a joint gift by husband and wife, the sole intervening interest or right is a nontransferable life interest reserved by the donors which expires not later than the death of whichever of such donors dies later.

For purposes of the preceding sentence, the right to make a transfer of the reserved life interest to the donee of the future interest shall not be treated as making a life interest transferable.

(e) *Transfers subject to a condition or a 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 passes to or is vested in charity on the date of the gift and the interest would be defeated by the performance of some act or the happening of some event, the occurrence of which appeared to have been highly improbable on the date of the gift, the deduction is allowable. The deduction is not allowed in the case of a transfer in trust conveying a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in trust consist of stock in a corporation the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees were not members of the donor's family but had no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction would be allowed.

(f) *Exceptions.* (1) This section does not apply to contributions by estates and trusts (see section 642(c)). For disallowance of certain charitable deductions otherwise allowable under section 170, see sections 503(e) and 681(b)(5) (relating to organizations engaged in prohibited transactions). 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). For denial of deduction 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.

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

(i) A substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, or

(ii) Which participates in or intervenes in any political campaign on behalf of any candidate for public office.

For purposes of determining whether an organization is attempting to influence legislation or is engaging in political activities, see section 501(c)(3) and the regulations thereunder. Moreover, no deduction shall be allowed under section 170 for expenditures for lobbying purposes, promotion or defeat of legislation, etc. See also the regulations under section 162.

(3) 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) 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). In the case of a nonresident alien individual, or a citizen of the United States entitled to the benefits of section 931, see sections 873(c), 876, and 931.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8094, Aug. 15, 1962; T.D. 6785, 29 FR 18499, Dec. 29, 1964; T.D. 6832, 30 FR 8574, July 7, 1965; T.D. 6900, 31 FR 14633, Nov. 17, 1966; T.D. 7084, 36 FR 266, Jan. 8, 1971; T.D. 7207, 37 FR 20768, Oct. 4, 1972]

§ 1.170–2 Charitable deductions by individuals; limitations (before amendment by Tax Reform Act of 1969).

(a) *In general.* (1) A deduction is allowable to an individual under section 170 only for charitable contributions actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. A contribution to

an organization described in section 170(c) is deductible even though some portion of the funds of the organization may be used in foreign countries for charitable or educational purposes. The deduction by an individual for charitable contributions under section 170 is limited generally to 20 percent of the taxpayer's adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). 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 limitation in section 170(b) is based on the aggregate adjusted gross income of the spouses. The 20-percent limitation applies to amounts contributed during the taxable year ''to or for the use of'' those recipients described in section 170(c), including amounts treated under section 170(d) as paid for the use of an organization described in section 170(c)(2), (3), or (4). See paragraph (f) of this section. The limitation is computed without regard to contributions qualifying for the additional 10-percent deduction. For examples of the application of the 10- and 20-percent limitation, see paragraph (b)(5) of this section. For special rules reducing amount of certain charitable deductions, see paragraph (c)(2) of § 1.170–1.

(2) No deduction is allowable for 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 rendering donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of rendering donated services also are deductible. For the purposes of this section, the phrase *while away from home* has the same meaning as that phrase is used for purposes of section 162.

(3)(i) 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.

(ii) The value of the annuity or portion is the value of the annuity determined in accordance with section 101(b) and the regulations thereunder.

(b) *Additional 10-percent deduction*—(1) *In general.* In addition to the deduction which may be allowed for contributions subject to the general 20-percent limitation, an individual may deduct charitable contributions made during the taxable year to the organizations specified in section 170(b)(1)(A) to the extent that such contributions in the aggregate do not exceed 10 percent of his adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172). The additional 10-percent deduction may be allowed with respect to contributions to:

(i) A church or a convention or association of churches,

(ii) An educational organization referred to in section 503(b)(2) and defined in subparagraph (3)(i) of this paragraph,

(iii) A hospital referred to in section 503(b)(5) and defined in subparagraph (4)(i) of this paragraph,

(iv) Subject to certain conditions and limitations set forth in subparagraph (4)(ii) of this paragraph, and for taxable years beginning after December 31, 1955, a medical research organization referred to in section 503(b)(5),

(v) Subject to certain limitations and conditions set forth in subparagraph (3)(ii) of this paragraph, and for taxable years beginning after December 31, 1960, an organization referred to in section 503(b)(3) which is organized and operated for the benefit of certain State and municipal colleges and universities,

(vi) For taxable years beginning after December 31, 1963, a governmental unit referred to in section 170(c)(1), and

(vii) Subject to certain limitations and conditions set forth in subparagraph (5) of this paragraph, and for taxable years beginning after December 31, 1963, an organization referred to in section 170(c)(2).

To qualify for the additional 10-percent deduction 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 an organization specified in subdivisions (i) through (vi) of this subparagraph) which, for taxable years beginning after December 31, 1963, is not ''publicly supported'' under the rules of subparagraph (5) of this paragraph will not qualify for the additional 10-percent deduction even though such organization makes the contribution available to an organization which is specified in section 170(b)(1)(A). The computation of this additional deduction is not necessary unless the total contributions paid during the taxable year are in excess of the general 20-percent limitation. Where the total contributions exceed the 20-percent limitation, the taxpayer should first ascertain the amount of charitable contributions subject to the 10-percent limitation, and any excess over the 10-percent limitation should then be added to all other contributions and limited by the 20-percent limitation. For provisions relating to a carryover of certain charitable contributions made by individuals, see paragraph (g) of this section.

(2) *Church.* For definition of *church,* see the regulations under section 511.

(3) *Educational organization and organizations for the benefit of certain State and municipal colleges and universities*—(i) *Educational organization.* An *educational organization* within the meaning of section 170(b)(1)(A) is one whose primary function is the presentation of formal instruction and which 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, therefore, 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 and growing out of the educational activities. A recognized university which incidentally operates a museum or sponsors concerts is an educational organization. However, the operation of a school by a museum does not necessarily qualify the museum as an educational organization. A gift to an educational institution through an alumni association or a class organization, which acts simply as a fund-raising or collection agency through which gifts may be made currently to the institution, is a gift to the educational organization if the entire gift inures to its benefit, but not if any part of it inures to the general or operating fund of the agency. Similarly, a gift to one or more educational institutions through an association of educational institutions will be considered a gift to the institutions if it inures entirely to their benefit.

(ii) *Organizations for the benefit of certain State and municipal colleges and universities.* (a) For taxable years beginning after December 31, 1960, gifts made to an organization referred to in section 503(b)(3) organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of certain colleges and universities, may be taken into account in computing the additional 10-percent limitation. The phrase *expenditures to or for the benefit of certain colleges and universities* includes expenditures made for any one or more of the normally accepted functions of colleges and universities, for example, for 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, scholarships, libraries, student loans, and the acquisition and maintenance of equipment and furnishings used for or in conjunction with normally accepted functions of colleges and universities.

(*b*) The recipient organization must be one which normally receives a substantial portion 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. An example of an indirect contribution from the public would be 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.

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

(4) *Hospital and medical research organization*—(i) *Hospital.* The term *hospital,* as used in section 170(b)(1)(A), means an organization the principal purposes or functions of which are the providing of hospital or medical care. The term includes Federal and State hospitals otherwise coming within the definition but does not include medical education organizations, or medical research organizations. See, however, subdivision (ii) of this subparagraph, relating to contributions to certain medical research organizations for taxable years beginning after December 31, 1955. A rehabilitation institution or an outpatient clinic may qualify as a hospital if its principal purposes or functions are the providing of hospital or medical care. The term *hospital* does not include convalescent homes or homes for children or the aged, nor does the term include institutions whose principal purposes or functions are to train handicapped individuals to pursue some vocation.

(ii) *Certain medical research organizations.* (*a*) For taxable years beginning after December 31, 1955, certain charitable contributions made to certain medical research organizations may be taken into account in computing the additional 10-percent limitation. To be so taken into account the charitable contribution must be made to a medical research organization that is directly engaged in the continuous active conduct of medical research in conjunction with a hospital (as defined in subdivision (i) of this subparagraph), and, during the calendar year in which the contribution is made, the organization must be committed to spend the contribution for such active conduct of medical research before January 1 of the fifth calendar year beginning after the date the contribution is made.

(*b*) As used in section 170(b)(1)(A) and this subparagraph, the term *medical research organization* means an organization the principal purpose or function of which is to engage in medical research. Medical research may be defined as 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 the appropriate equipment and professional personnel necessary to carry out its principal function.

(*c*) The organization must, at the time of the contribution, be directly engaged in the continuous active conduct of medical research in conjunction with a hospital described in subdivision (i) of this subparagraph. The organization need not be formally affiliated with a hospital to be considered engaged in the active conduct of medical research in conjunction with a hospital, but it must be physically connected, or closely associated, with a hospital. In any case, there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations shall 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 provided that the organization is permitted to utilize the facilities (including equipment, case studies, etc.) of the hospital on a continuing basis in the active conduct of medical research. A medical research organization which is closely associated, in the manner described above, with a particular hospital or particular hospitals, may be considered to be pursuing research in conjunction with a hospital if the necessary joint effort is supported by substantial evidence of the close cooperation of the members of the research organization and the

staff of the particular hospital or hospitals. The active participation in medical research by the staff of the particular hospital or hospitals will be considered as evidence of the requisite joint effort. If the organization's primary purpose is to disburse funds to other organizations for the conduct of research by them, or, if the organization's primary purpose is to extend research grants or scholarships to others, it is not directly engaged in the active conduct of medical research, and contributions to such an organization may not be taken into account for purposes of the additional 10-percent limitation.

(*d*) A charitable contribution to a medical research organization may be taken into account in computing the additional 10-percent limitation only if the organization is committed to spend such contribution for medical research in conjunction with a hospital on or before the first day of the fifth calendar year which begins after the date the contribution is made. 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 shall ordinarily be considered to be an expenditure for medical research for purposes of section 170(b) and this section. 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.

(5) *Corporation, trust, or community chest, fund, or foundation*—(i) *In general.* (*a*) For taxable years beginning after December 31, 1963, gifts made to a corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2) (other than an organization specified in subparagraph (1) (i) through (vi) of this paragraph), may be taken into account in computing the additional 10-percent limitation, provided the organization is a ''publicly supported'' organization. For purposes of this subparagraph, an organization is ''publicly supported'' if it 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.

(*b*) An important factor in determining whether an organization normally receives a substantial part of its support from ''direct or indirect contributions from the general public'' is the extent to which the organization derives its support from or through voluntary contributions made by persons representing the general public. Except in unusual situations (particularly in the case of newly created organizations), an organization is not ''publicly supported'' if it receives contributions only from the members of a single family or from a few individuals.

(ii) *Special rules and meaning of terms.* (*a*) For purposes of this subparagraph, the term *support*, except as otherwise provided in (*b*) of this subdivision (ii), means all forms of support including (but not limited to) contributions received by the organization, investment income (such as, interest, rents, royalties, and dividends), and net income from unrelated business activities whether or not such activities are carried on regularly as a trade or business.

(*b*) The term *support* does not include:

(*1*) 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).

(*2*) Any gain upon the sale or exchange of property which would be considered under any section of the Code as gain from the sale or exchange of a capital asset.

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

(*c*) The term *support from a governmental unit* includes:

(*1*) 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, provided such amounts are not excluded from the term *support* under (*b*) of this subdivision (ii). For purposes of (*b*)(*1*) of this subdivision (ii), an amount paid by a governmental unit to an organization is not 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) if the purpose of the payment is to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public, as, for example, the maintenance of library facilities which are open to the public.

(*2*) Tax revenues levied for the benefit of the organization and either paid to or expended on behalf of the organization.

(*3*) The value of services or facilities (exclusive of services or facilities generally furnished, without charge, to the public) furnished by a governmental unit to the organization without charge, as, for example, where a city pays the salaries of personnel used to guard a museum, art gallery, etc., or provides, rent free, the use of a building. However, the term does not include the value of any exemption from Federal, State, or local tax or any similar benefit.

(*d*) The term *indirect contributions from the general public* includes contributions received by the organization from organizations which normally receive a substantial part of their support from direct contributions from the general public.

(iii) *Determination of whether organization is ''publicly supported''—(a) In general.* No single test which would be appropriate in every case may be prescribed for determining whether a corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2), is ''publicly supported''. For example, since the statutory test is whether the organization normally receives a substantial part of its support from the prescribed sources, a test which would be appropriate in the case of an organization which has been in operation for a number of years would not necessarily be appropriate in the case of a newly established organization. The determination of whether an organization is ''publicly supported'' depends on the facts and circumstances in each case. Thus, although a ''mechanical test'' is set forth in (*b*) of this subdivision (iii), such test is not an exclusive test. Accordingly, an organization which does not qualify as a ''publicly supported'' organization by application of the ''mechanical test'' may qualify as a ''publicly supported'' organization on the basis of the facts and circumstances in its case. For provisions relating to the facts and circumstances test, see (*c*) of this subdivision (iii).

(*b*) *Mechanical test.* An organization will be considered to be a ''publicly supported'' organization for its current taxable year and the taxable year immediately succeeding its current year, if, for the four taxable years immediately preceding the current taxable year, the total amount of the support which the organization receives from governmental units, from donations made directly or indirectly by the general public, or from a combination of these sources equals 33⅓ percent or more of the total support of the organization for such four taxable years. The rule in the preceding sentence does not apply if there are substantial changes in the organization's character, purposes, or methods of operation in the current year, and does not apply in respect of the immediately succeeding taxable year if such changes occur in such year. In determining whether the 33⅓-percent-of-support test is met, contributions by an individual, trust, or corporation shall be taken into account only to the extent that the total amount of the contributions by any such individual, trust, or corporation during the four-taxable-year period does not exceed 1 percent of the organization's total support for such four taxable years. In applying the 1-percent limitation, all contributions made by a

donor and by any person or persons standing in a relationship to the donor which is described in section 267(b) and the regulations thereunder shall be treated as made by one person. The 1-percent limitation shall not apply to support from governmental units referred to in section 170(c)(1) or to contributions from ''publicly supported'' organizations. A national organization which carries out its purposes through local chapters with which it has an identity of aims and purposes may, for purposes of determining whether the organization and the local chapters meet the mechanical test, make the computation on an aggregate basis.

Example. For the years 1964 through 1967, X, an organization referred to in section 170(c)(2), received support (as defined in subdivision (ii) of this subparagraph) of $600,000 from the following sources:

Investment income	$300,000
City Y (a governmental unit referred to in section 170(c)(1))	40,000
United Fund (an organization referred to in section 170(c)(2) which is "publicly supported")	40,000
Contributions	220,000
Total support	600,000

For the years 1964 through 1967, X received in excess of 33⅓ percent of its support from a governmental unit referred to in section 170(c)(1) and from direct and indirect contributions from the general public computed as follows:

33⅓ percent of total support	$200,000
Support from a governmental unit referred to in section 170(c)(1)	40,000
Indirect contributions from the general public (United Fund)	40,000
Contributions by various donors (no one donor having made contributions which total in excess of $6,000—1 percent of total support)	50,000
12 contributions (each in excess of $6,000—1 percent of total support) 12×$6,000	72,000
	202,000

Since the amount of X's support from governmental units referred to in section 170 (c)(1) and from direct and indirect contributions from the general public in the years 1964 through 1967 is in excess of 33⅓ percent of X's total support for such four taxable years, X is considered a ''publicly supported'' organization with respect to contributions made to it during 1968 and 1969 without regard to whether X receives 33⅓ percent of its support during 1968 or 1969 from such sources (assuming that there are no substantial changes in X's character, purposes, or methods of operation).

(*c*) Facts and circumstances test. (*1*) A corporation, trust, or community chest, fund or foundation referred to in section 170(c)(2) which does not qualify as a ''publicly supported'' organization under the mechanical test described in (b) of this subdivision (iii) (including an organization which has not been in existence for a sufficient length of time to make such test applicable) may be a ''publicly supported'' organization on the basis of the facts and circumstances in its case.

(*2*) The facts and circumstances which are relevant and the weight to be accorded such facts and circumstances may differ in certain cases depending, for example, on the nature of the organization and the period of time it has been in existence. However, under no circumstances will an organization which normally receives substantially all of its contributions (directly or indirectly) from the members of a single family or from a few individuals qualify as a ''publicly supported'' organization.

(*3*) For purposes of the facts and circumstances test the most important consideration is the organization's source of support. An organization will be considered a ''publicly supported'' organization if it is constituted so as to attract substantial support from contributions, directly or indirectly, from a representative number of persons in the community or area in which it operates. In determining what is a ''representative number of persons,'' consideration must be given to the type of organization and whether or not the organization limits its activities to a special field which can be expected to appeal to a limited number of persons. An organization is so constituted if, for example, it establishes that it does in fact receive substantial support from contributions from a representative number of persons; that pursuant to its organizational structure and method of operation it makes bona fide solicitations for broad based public support, or, in the case of a newly created organization, that its organizational structure and method of operation are such as to require bona fide solicitations for broad based public support; that it receives substantial support from a community chest or

similar public federated fund raising organization, such as a United Fund or United Appeal; or that it has a substantial number of members (in relation to the community it serves, the nature of its activities, and its total support) who pay annual membership dues.

(*4*) Although primary consideration will be given to the source of an organization's support, other relevant factors may be taken into account in determining whether or not the organization is of a public nature, such as:

(*i*) Whether the organization has a governing body (whether designated in the organization's bylaws, certificate of incorporation, deed of trust, etc., as a Board of Directors, Board of Trustees, etc.) which is comprised of public officials, of individuals chosen by public officials acting in their capacity as such, or of citizens broadly representative of the interests and views of the public. This characteristic does not exist if the membership of an organization's governing body is such as to indicate that it represents the personal or private interests of a limited number of donors to the organization (or persons standing in a relationship to such donors which is described in section 267(b) and the regulations thereunder), rather than the interests of the community or the general public.

(*ii*) Whether the organization annually or more frequently makes available to the public financial reports or, in the case of a newly created organization, is constituted so as to require such reporting. For this purpose an information or other return made pursuant to a requirement of a governmental unit shall not be considered a financial report. An organization shall be considered as making financial reports of its operations available to the public if it publishes a financial report in a newspaper which is widely circulated in the community in which the organization operates or if it makes a bona fide dissemination of a brochure containing a financial report.

(*iii*) If the organization is of a type which generally holds open to the public its buildings (as in the case of a museum) or performances conducted by it (as in the case of a symphonic orchestra), whether the organization actually follows such practice, or, in the case of a newly created organization, is so organized as to require that its facilities be open to the public.

(*5*) The application of this subdivision (*c*) may be illustrated by the following examples:

Example 1. M, a community trust, is an organization referred to in section 170(c)(2). In 1950, M was organized in the X Community by several leading trusts and financial institutions with the purpose of serving permanently the educational and charitable needs of the X Community by providing a means by which the public may establish funds or make gifts of various amounts to established funds which are administered as an aggregate fund with provision for distribution of income and, in certain cases, principal for educational or charitable purposes by a single impartial committee. The M Organization, by distribution of pamphlets to the public through participating trustee banks, actively solicits members of the X Community and other concerned parties to establish funds within the trust or to contribute to established funds within the trust. Under the declaration of trust, a contributor to a fund may suggest or request (but not require) that his contribution be used in respect of his preferred charitable, educational, or other benevolent purpose, and distributions of the income from the fund, and in certain cases the principal, will be made by the Distribution Committee with regard to such request unless changing conditions make such purpose unnecessary, undesirable, impractical, or impossible in which case income and (where the contributor has so specified) principal will be distributed by the Distribution Committee in order to promote the public welfare more effectively. Where a contributor has not expressed a desire as to a charitable, educational, or other benevolent purpose, the Distribution Committee will distribute the entire annual income from the fund to such a purpose agreed upon by such committee. The Distribution Committee is composed of representatives of the community chosen one each by the X Bar Association, the X Medical Society, the mayor of X Community, the judge of the highest X Court, and the president of the X College, and two representatives chosen by the participating trustee banks. There are a number of separate funds within the trust administered by several participating banks. M has consistently distributed or used its entire annual income for projects with purposes described in section 170(c)(2)(B) from which members of the public may benefit or to other organizations described in section 170(b)(1)(A) which so distribute or use such income. Through its participating trustee banks, M annually makes available to the public a brochure containing a financial

statement of its operations including a list of all receipts and disbursements. Under the facts and circumstances, M is a ''publicly supported'' organization.

Example 2. Assume the same facts as in *Example 1* except that M has been in existence for only one year and only two contributors have established funds within the trust. The Distribution Committee has been chosen and is required by the governing declaration of trust to make annual distribution of the entire income of the trust to projects with purposes described in section 170(c)(2)(B) from which members of the public may benefit or to other organizations described in section 170(b)(1)(A) which so distribute or use such income. The declaration of trust and other governing instruments require (1) that the M Community Trust actively solicit contributions from members of the X Community through dissemination of literature and other public appeals, and (2) that it make available to the members of the X Community, annual financial reports of its operations. Under the facts and circumstances, M is a ''publicly supported'' organization.

Example 3. N, an art museum, is an organization referred to in section 170(c)(2). In 1930, N was founded in Y City by the members of a single family to collect, preserve, interpret, and display to the public important works of art. N is governed by a self-perpetuating Board of Trustees limited by the governing instruments to a maximum membership of 20 individuals. The original board consisted almost entirely of members of the founding family. Since 1945, members of the founding family or persons standing in a relationship to the members of such family described in section 267(b) have annually constituted less than one-fifth of the Board of Trustees. The remaining board members are citizens of Y City from a variety of professions and occupations who represent the interests and views of the people of Y City in the activities carried on by the organization rather than the personal or private interests of the founding family. N solicits contributions from the general public and for each of its four most recent taxable years has received total contributions in small sums (less than $100) in excess of $10,000. For N's four most recent taxable years, investment income from several large endowment funds has constituted 75 percent of its total support. N normally expends a substantial part of its annual income for purposes described in section 170(c)(2)(B). N has, for the entire period of its existence, been open to the public and more than 300,000 people (from the Y City and elsewhere) have visited the museum in each of its four most recent taxable years. N annually publishes a financial report of its operation in the Y City newspaper. Under the facts and circumstances, N museum is a ''publicly supported'' organization.

Example 4. In 1960, the O Philharmonic Orchestra was organized in Z 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. O is an organization referred to in section 170(c)(2). The orchestra is composed of professional musicians who are paid by the association. Twelve performances, open to the public, are scheduled each year. The admission charge for each of these performances is $3. In addition, several performances are staged annually without charge. In each of its four most recent taxable years, O has received separate contributions of $10,000 from A, B, C, and D (not members of a single family) and support of $5,000 from the Z Community Chest, a public federated fund raising organization operating in Z City. O 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 the Board and represent the interests and views of the community in the activities carried on by O. O annually files a financial report with Z City which makes such report available for public inspection. Under the facts and circumstances, O is a ''publicly supported'' organization.

Example 5. P is a newly created organization of a type referred to in section 170 (c)(2). P's charter requires that its governing body be selected by public officials and by public organizations representing the community in which it operates. Pursuant to P's charter, a continuing fund raising campaign which will encompass the entire community has been planned. P's charter requires that its entire annual income be distributed to or used for projects with purposes described in section 170(c)(2)(B) and that it make available to the public annual financial reports of its operations. By reason of the express provisions of P's charter relating to its organizational structure and prescribed methods of operation, P is a ''publicly supported'' organization.

(*6*) *Examples.* The application of the special 10-percent limitation and the general 20-percent limitation on contributions by individuals may be illustrated by the following examples:

Example 1. A, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	$2,400	
2. Other charitable contributions	700	
3. Total contributions paid	3,100	
		Deductible contributions
4. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	2,400	
5. Special limitation under section 170(b)(1)(A): 10 percent of adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$1,000
7. Excess of line 4 over line 5	1,400	
8. Add: Other charitable contributions	700	
9. Contributions subject to the general 20-percent limitation under section 170(b)(1)(B)	2,100	
10. Limitation under section 170(b)(1)(B): 20 percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	100	
13. Total deduction for contributions		3,000

Example 2. B, an individual, reports his income on the calendar year basis and for the year 1957 has an adjusted gross income of $10,000. During 1957 he made the following charitable contributions:

1. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	$700	
2. Other charitable contributions	2,400	
3. Total contributions paid	3,100	
4. Contributions qualifying for the additional 10-percent deduction under section 170(b)(1)(A)	700	
5. Limitation described in section 170(b)(1)(A): 10 percent of the adjusted gross income	1,000	
6. Deductible amount: line 4 or line 5, whichever is the lesser		$700
7. Excess of line 4 over line 5	0	
8. Add: Other charitable contributions	2,400	
9. Contributions subject to the general 20-percent limitation under section 170(b)(1)(B)	2,400	
10. Limitation under section 170(b)(1)(B): 20 percent of the adjusted gross income	2,000	
11. Deductible amount: line 9 or line 10, whichever is the lesser		2,000
12. Contributions not deductible	400	
13. Total deduction for contributions		2,700

(c) *Unlimited deduction for individuals*—(1) *In general.* (i) The deduction for charitable contributions made by an individual is not subject to the 10- and 20-percent limitations of section 170(b) if in the taxable year and each of 8 of the 10 preceding taxable years the sum of his charitable contributions paid during the year, plus his payments during the year on account of Federal income taxes, is more than 90 percent of his taxable income for the year (or net income, in years governed by the Internal Revenue Code of 1939). In determining the applicability of the 10- and 20-percent limitations of section 170(b) for taxable years beginning after December 31, 1957, there may be substituted, in lieu of the amount of income tax paid during any year, the amount of income tax paid in respect of such year, provided that any amount so included for the year in respect of which payment was made shall not be included for any other year. For the purpose of the first sentence of this paragraph, taxable income under the 1954 Code is determined without regard to the deductions for charitable contributions under section 170, for personal exemptions under section 151, or for a net operating loss carryback under section 172. On the other hand, for this purpose net income under the

1939 Code is computed without the benefit only of the deduction for charitable contributions. See section 120 of the Internal Revenue Code of 1939. The term *income tax* as used in section 170(b)(1)(C) means only Federal income taxes, and does not include the taxes imposed on self-employment income, on employees under the Federal Insurance Contributions Act, and on railroad employees and their representatives under the Railroad Retirement Tax Act by Chapters 2, 21, and 22, respectively, or corresponding provisions of the Internal Revenue Code of 1939. For purposes of section 170(b)(1)(C) and this paragraph, the amount of income tax paid during a taxable year shall be determined (except as provided in subdivision (ii) of this subparagraph) by including all payments made by the taxpayer during such taxable year on account of his Federal income taxes (whether for the taxable year or for preceding taxable years). Such payments would include any amount paid during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter (2) for that year, payment of the final installment of estimated tax (exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by chapter 2) for the preceding taxable year, final payment for the preceding taxable year, and any payment of a deficiency for an earlier taxable year, to the extent that such payments do not exceed the tax for the taxable year for which payment is made. Any payment of income tax with respect to which the taxpayer receives a refund or credit shall be reduced by the amount of such refund or credit. Any such refund or credit shall be applied against the most recent payments for the taxable year in respect of which the refund or credit arose.

(ii) For any taxable year beginning after December 31, 1957, the applicability of the 10- and 20-percent limitations of section 170(b) may be determined either with reference to the income tax paid during the year or any prior year, or with reference to the income tax paid in respect of any such year or prior years. The 90-percent test of section 170(b)(1)(C) may be applied for the taxable year, or for any one or more of the preceding 10 taxable years, by taking into account the income taxes paid in respect of that year or years, and for the balance of the 10 years by taking into account the income tax payments made during those years. Thus, a taxable year which qualifies under either of the two permissible methods shall be considered as a qualifying year irrespective of whether the taxable year begins before or after December 31, 1957. However, a particular income tax payment may only be taken into account once, either with respect to the year of liability or for the year of payment.

(2) *Joint returns*—(i) *Joint return for current taxable year.* If a husband and wife make a joint return for any taxable year, their deduction for charitable contributions is not subject to the 10- and 20-percent limitations of section 170(b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and in each of 8 of the 10 preceding taxable years (regardless of whether separate or joint returns were filed), the aggregate charitable contributions of both spouses paid during the year, plus their aggregate payments during the year on account of Federal income taxes (or, if the taxable year begins after December 31, 1957, the aggregate tax paid in respect of such taxable year or any preceding taxable year) exceed 90 percent of their aggregate taxable incomes for the year.

(ii) *Separate return by spouse or by unremarried widow or widower.* If a spouse, or the unremarried widow or widower of a deceased spouse, makes a separate return for any taxable year, his deduction for charitable contributions is not subject to the 10- and 20-percent limitations of section 170(b), if, under the rules of subparagraph (1) of this paragraph, in the taxable year and each of 8 of the 10 preceding taxable years:

(*a*) For which the taxpayer filed a joint return with his spouse, either their aggregate charitable contributions and payments of Federal income taxes made during the taxable year (or

if the taxable year begins after December 31, 1957, made in respect of such taxable year or any preceding taxable year) exceed 90 percent of their aggregate taxable income for that year, or the taxpayer's separate charitable contributions and payments of Federal income taxes allocable to his separate income and made during the taxable year (or if the taxable year begins after December 31, 1957, made in respect of such taxable year or any preceding taxable year) exceed 90 percent of his separate taxable income for that year, and (*b*) For which the taxpayer did not file a joint return with his spouse, the aggregate of his charitable contributions and payments of Federal income taxes made during the taxable year (or, if the taxable year begins after December 31, 1957, the payments of income taxes made in respect of such taxable year or any preceding taxable year) exceeds 90 percent of his taxable income for that year.

For the purpose of the preceding sentence, the word *spouse* does not include a spouse from whom the taxpayer has been divorced.

(iii) *Joint return with former spouse for prior taxable year.* A divorced or remarried taxpayer who filed a joint return for a prior taxable year with a former spouse shall, for purposes of applying this paragraph, be treated in the same manner as if he had filed a separate return for such prior taxable year, and as if his Federal income tax liability and taxable income for such prior taxable year were his allocable portions of the joint tax liability and combined taxable income, respectively, for such year.

(iv) *Allocation.* Whenever it is necessary to allocate the joint tax liability or the combined taxable income, or both, for a taxable year for which a joint return was filed, a computation shall be made for the taxpayer and for his spouse or former spouse showing for each of them the Federal income taxes and taxable income which would be determined if separate returns had been filed by them for such taxable year. The joint tax liability and conbined taxable income for such taxable year shall then be allocated proportionately to the income taxes and taxable income, respectively, so computed. Whenever it is necessary to determine the separate payments made by a taxpayer in respect of a joint tax liability, the amount paid by him during the taxable year as estimated tax (exclusive of any portion of such amount for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by Chapter 2) for that year shall be included to the extent it does not exceed his allocable portion of the joint tax under Chapter 1 (exclusive of tax under section 56) for the taxable year, and any amount paid by him for a prior year (whether as the final installment of estimated tax—exclusive of any portion of such installment, for taxable years beginning after December 31, 1966, which is attributable to the self-employment tax imposed by Chapter 2—for the preceding taxable year, or a final payment for the preceding year, or the payment of a deficiency for an earlier year) shall be included to the extent such amount, when added to amounts previously paid by him for such prior year, does not exceed his allocable portion of the joint tax liability for the prior year.

(d) *Denial of deduction in case of certain transfers in trust*—(1) *Reversionary interest in grantor.* No charitable deduction will be allowed for the value of any interest in property transferred to a trust after March 9, 1954, if the grantor at the time of the transfer has a reversionary interest in the corpus or income and the value of such reversionary interest exceeds 5 percent of the total value on which the charitable deduction would, but for section 170(b)(1)(D), be determined. For purposes of this paragraph, the term *reversionary interest* means a possibility that after the possession or enjoyment of property or its income has been obtained by a charitable donee, the property or its income may revest in the grantor or his estate, or may be subject to a power exercisable by the grantor or a nonadverse party (within the meaning of section 672 (b)), or both, to revest in, or return to or for the benefit of, the grantor or his estate the property or income therefrom. An interest of the grantor which, in any event, will

terminate before the ripening of the assured charitable gift for which a deduction is claimed is not considered a reversionary interest for purposes of this section. For example, assume that a taxpayer conveyed property to a trust under the terms of which the income is payable to the taxpayer's wife for her life, and, if she predeceases him, to him for his life, and after the death of both the property is to be transferred to a charitable organization.

(2) *Valuation of interests.* The present value of the remainder interest in the property, taking into account the value of the life estates reserved to the taxpayer and his wife, may be allowed as a charitable deduction. Where the corpus of the trust is to return to the grantor after a number of years certain, the value of the reversionary interest at the time of the transfer may be computed by the use of tables showing the present value at 3 1/2 percent a year, compuounded annually, of $1 payable at the end of a number of years certain. See paragraph (f), Table II, of § 20.2031–7 of this chapter (Estate Tax Regulations). Where the value of a reversionary interest is dependent upon the continuation or termination of the life of one or more persons, it must be determined on the basis of Table 38 of United States Life Tables and Actuarial Tables 1939–1941, published by the United States Department of Commerce, Bureau of the Census, and interest at the rate of 3 1/2 percent a year, compounded annually. See paragraph (f), Table I, of § 20.2031–7 of this chapter (Estate Tax Regulations) for valuations based on one life, and ''Actuarial Values for Estate and Gift Tax'' (Internal Revenue Service Publication No. 11, Rev. 5–59) for values based on more than one life. In an actual case (not merely hypothetical), the grantor or his legal representative may, upon request, obtain the information necessary to determine such a value from the district director with whom the grantor files his return. The request must be accompanied by a statement showing the date of birth of each person the duration of whose life may affect the value of the reversionary interest and by copies of the instruments relevant to the transfer.

(e) *Fiscal years and short taxable years ending after March 9, 1954, subject to the Internal Revenue Code of 1939.* Pursuant to section 7851(a)(1)(C) of the Internal Revenue Code of 1954, the regulations prescribed in paragraph (d) of this section, to the extent that they relate to transfers in trust occurring after March 9, 1954, shall apply to all taxable years ending after March 9, 1954, even though those years may be subject to the Internal Revenue Code of 1939.

(f) *Amounts paid to maintain certain students as members of the taxpayer's household*—(1) *In General.* (i) For taxable years beginning after December 31, 1959, the term *charitable contribution* 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(d) and this paragraph, 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(d)(2) and paragraph (f)(2) of this section, are deductible contributions 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 twelfth or any lower grade at an educational institution (as defined in section 151(e)(4)) located in the United States. Amounts paid outside of the period (but within the taxable year) for expenses necessary for the maintenance of the student during the period

will qualify for the charitable deduction if the other limitation requirements of the section are met.

(ii) For purposes of paragraph (i) of this section, 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 school on a full-time basis. This would include amounts paid to ensure 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 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 paragraph 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.

(iii) For purposes of section 170(d) and this paragraph, 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.

(iv) As in the case of other charitable deductions, any deduction claimed for amounts described in section 170(d) and this paragraph which are treated as charitable contributions under section 170(c) is subject to verification by the district director. When claiming a deduction for such amounts, the taxpayer should submit 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 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 amounts spent for all members of the household, with an equal portion thereof allocated to each member, will be acceptable.

(2) *Limitations.* Section 170(d) and this paragraph 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 paragraph. 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 is deductible under section 170, subject to the 20-percent limitation provided in section 170(b)(1)(B). Also, see § 1.170–2(a)(1).

(3) *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 (f)(1) of this section, shall not be taken into account under section 170(d) of this paragraph, 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(d) 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 not generally 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.

(4) *No other amount allowed as deduction.* Except to the extent that amounts described in section 170(d) and this paragraph 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(d) and this paragraph.

(5) *Examples.* Application of the provisions of this paragraph 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 United States residents in order to further the children's high school education. In accordance with the provisions of subparagraph (1) of this paragraph, 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, 1960, where they remained until January 21, 1961, 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 tenth grade students and attended the school on a full-time basis for the spring semester starting January 18, 1960, and ending June 3, 1960, and for the fall semester starting September 1, 1960, and ending January 13, 1961. The total cost of food paid by A in 1960 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 8 1/2 months during 1960, 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(d) and this paragraph 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 subparagraph (2) of this paragraph. Since, for purposes of such limitations, the children were full-time students for only 8 full calendar months during 1960 (less than 15 days in January 1960), the taxpayer may treat only $800 as a charitable contribution made in 1960, 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(d). Also, because the children were full-time students for less than 15 days in January 1961 (although maintained in the taxpayer's household for 21 days), amounts paid to maintain the children during 1961 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 1960–61 school year. The child is a full-time student at the school during the school year starting September 6, 1960, and ending June 6, 1961, and is a member of the taxpayer's household during that period. Although the taxpayer pays $200 during the school period falling in 1960, and $240 during the school period falling in 1961, 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 subparagraph (3) of this paragraph. 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 deduction. These substantial gratuitous services are considered property received as reimbursement under subparagraph (3) of this paragraph.

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 1961 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 1961. 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(d). 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.

(g) *Charitable contributions carryover of individuals*—(1) *Computation of excess charitable contributions made in contribution year.* Subject to certain conditions and limitations, the excess of:

(i) The amount of the charitable contributions made by an individual in a taxable year beginning after December 31, 1963 (hereinafter in this paragraph referred to as the ''contribution year''), to organizations specified in section 170(b)(1)(A) (see paragraph (b) of this section), over

(ii) Thirty percent of his adjusted gross income (computed without regard to any net operating loss carryback to such year under section 172) for such contribution year, shall be treated as a charitable contribution paid by him to an organization specified in section 170(b)(1)(A) and paragraph (b) of this section, relating to the additional 10-percent deduction, in each of the 5 taxable years immediately succeeding the contribution year in order of time. (For provisions requiring a reduction of such excess, see subparagraph (5) of this paragraph.) The provisions of this subparagraph apply even though the taxpayer elects under section 144 to take the standard deduction in the contribution year instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income for the contribution year. No excess charitable contribution carryover shall be allowed with respect to contributions ''for the use of'' rather than ''to'' organizations described in section 170(b)(1)(A) and paragraph (b) of this section or with respect to contributions made ''to'' or ''for the use of'' organizations which are not described in such sections. The provisions of section 170(b)(5) and this paragraph are not applicable in the case of estates or trusts, see section 642(c), relating to deductions for amounts paid or permanently set aside for a charitable purpose, and the regulations thereunder. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that H and W (husband and wife) have adjusted gross income for 1964 of $50,000 and for 1965 of $40,000 and file a joint return for each year. Assume further that in 1964 they contribute $16,500 to a church and $1,000 to X (an organization not referred to in section 170(b)(1)(A)) and in 1965 contribute $11,000 to the church and $400 to X. They may claim a charitable contribution deduction of $15,000 in 1964, and the excess of $16,500 (contribution to the church) over $15,000 (30 percent of adjusted gross income) or $1,500 constitutes a charitable contribution carryover which shall be treated as a charitable contribution paid by them to an organization referred to in section 170(b)(1)(A) 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 1964. Since 30 percent of their adjusted gross income for 1965 ($12,000) exceeds the charitable contributions of $11,000 made by them in 1965 to organizations referred to in section 170(b)(1)(A) (computed

without regard to section 170(b)(5) and this paragraph) the portion of the 1964 carryover equal to such excess of $1,000 ($12,000 minus $11,000) is treated, pursuant to the provisions of subparagraph (2) of this paragraph, as paid to a section 170(b)(1)(A) organization in 1965; the remaining $500 constitutes an unused charitable contribution carryover. No carryover is allowed with respect to the $400 contribution made to X in 1965.

Example 2. Assume the same facts as in *Example 1* except that H and W have adjusted gross income for 1965 of $42,000. Since 30 percent of their adjusted gross income for 1965 ($12,600) exceeds by $1,600 the charitable contribution of $11,000 made by them in 1965 to organizations referred to in section 170(b)(1)(A) (computed without regard to section 170(b)(5) and this paragraph), the full amount of the 1964 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 1965. They may also claim a charitable contribution of $100 ($12,600 −$12,500 ($11,000+$1,500)) with respect to the gift to X in 1965. No carryover is allowed with respect to the $300 ($400−$100) of the contribution to X which is not deductible in 1965.

(2) *Determination of amount treated as paid in taxable years succeeding contribution year.* Notwithstanding the provisions of subparagraph (1) of this paragraph, the amount of the excess computed in accordance with the provisions of subparagraphs (1) and (5) of this paragraph which is to be treated as paid in any one of the 5 taxable years immediately succeeding the contribution year to an organization specified in section 170(b)(1)(A) shall not exceed the lesser of the amount computed under subdivision (i) or (ii) of this subparagraph:

(i) The amount by which (*a*) 30 percent of the taxpayer's adjusted gross income for such succeeding taxable year (computed without regard to any net operating loss carryback to such succeeding taxable year under section 172) exceeds (*b*) the sum of (*1*) the charitable contributions actually made (computed without regard to the provisions of section 170(b)(5) and this paragraph) by the taxpayer in such succeeding taxable year to organizations referred to in section 170(b)(1)(A), and (2) the charitable contributions made to organizations referred to in section 170(b)(1)(A) in taxable years (excluding any taxable year beginning before January 1, 1964) preceding the contribution year which, pursuant to the provisions of section 170(b)(5) and this paragraph, are treated as having been paid to an organization referred to in section 170(b)(1)(A) 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 subparagraphs (1) and (5) of this paragraph. In the case of the second, third, fourth, and fifth succeeding taxable years, the portion of the excess charitable contribution in the contribution year (computed under subparagraphs (1) and (5) of this paragraph) 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.

If a taxpayer, in any one of the four taxable years succeeding a contribution year, elects under section 144 to take the standard deduction in the amount provided for in section 141 instead of itemizing the deductions (other than those specified in sections 62 and 151) allowable in computing taxable income, there shall be treated as paid (but not allowable as a deduction) in the standard deduction year the amount determined under subdivision (i) or (ii) of this subparagraph, whichever is the lesser. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Assume that B has adjusted gross income for 1966 of $20,000 and for 1967 of $30,000. Assume further that in 1966 B contributed $8,000 to a church and in 1967 he contributes $7,500 to the church. B may claim a charitable contribution deduction of $6,000 in 1966, and the excess of $8,000 (contribution to the church) over $6,000 (30 percent of B's adjusted gross income) or $2,000 constitutes a charitable contribution carryover which shall be treated as a charitable contribution paid by B to an organization referred to in section 170(b)(1)(A) in the 5 taxable years succeeding 1966 in order of time. (B made no excess contributions in 1964 or 1965 which should be treated as paid in years succeeding 1964 or 1965.) B may claim a charitable contribution deduction of $9,000 in 1967. Such $9,000 consists of the $7,500 contribution to the church in 1967 and $1,500 carried over from 1966 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. The $1,500 contribution

treated as paid in 1967 is computed as follows:

1966 excess contributions		$2,000
30 percent of B's adjusted gross income for 1967		9,000
Less:		
Contributions actually made in 1967 to section 170(b)(1)(A) organizations	$7,500	
Contributions made to section 170(b)(1)(A) organizations in taxable years prior to 1966 treated as having been paid in 1967	0	7,500
		1,500
Amount of 1966 excess treated as paid in 1967—the lesser of $2,000 (1966 excess contributions) or $1,500 (30 percent of adjusted gross income for 1967 ($9,000) over the section 170(b)(1)(A) contributions actually made in 1967 ($7,500) and the section 170(b)(1)(A) contributions made in years prior to 1966 treated as having been paid in 1967 (0))		1,500

If the excess contributions made by B in 1966 had been $1,000 instead of $2,000, then, for purposes of this example, the amount of the 1966 excess treated as paid in 1967 would be $1,000 rather than $1,500.

Example 2. Assume the same facts as in *Example 1,* and, in addition, that B has adjusted gross income for 1968 of $10,000 and for 1969 of $20,000. Assume further with respect to 1968 that B elects under section 144 to take the standard deduction in computing taxable income and that his actual contributions to organizations specified in section 170(b)(1)(A) are $300. Assume further with respect to 1969, that B itemizes his deductions which include a $5,000 contribution to a church. B's deductions for 1968 are not increased by reason of the $500 available as a charitable contribution carryover from 1966 (excess contributions made in 1966 ($2,000) less the amount of such excess treated as paid in 1967 ($1,500)) since B elected to take the standard deduction in 1968. However, for purposes of determining the amount of the excess charitable contributions made in 1966 which is available as a carryover to 1969, B is required to treat such $500 as a charitable contribution paid in 1968—the lesser of $500 or $2,700 (30 percent of adjusted gross income ($3,000) over contributions actually made in 1968 to section 170(b)(1)(A) organizations ($300)). Therefore, even though the $5,000 contribution made by B in 1969 to a church does not amount to 30 percent of B's adjusted gross income for 1969 (30 percent of $20,000=$6,000), B may claim a charitable contribution deduction of only the $5,000 actually paid in 1969 since the entire excess charitable contribution made in 1966 ($2,000) has been treated as paid in 1967 ($1,500) and 1968 ($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:

	1964	1965	1966	1967	1968
Adjusted gross income	$10,000	$7,000	$15,000	$10,000	$9,000
Contributions to section 170(b)(1)(A) organizations (no other contributions)	4,000	3,000	5,000	1,000	1,500
Allowable charitable contributions deductions computed without regard to carryover of contributions	3,000	2,100	4,500	1,000	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 1967 and 1968 to section 170(b)(1)(A) organizations are less than 30 percent of his adjusted gross income for such years, the excess contributions for 1964, 1965, and 1966 are treated as having been paid to section 170(b)(1)(A) organizations in 1967 and 1968 as follows:

1967

Contribution year	*Total excess*	*Less: Amount treated as paid in year prior to 1967*	*Available charitable contribution carryovers*
1964	$1,000	0	$1,000
1965	900	0	900
1966	500	0	500

1967

Contribution year	*Total excess*	*Less: Amount treated as paid in year prior to 1967*	*Available charitable contribution carryovers*
			2,400
30 percent of B's adjusted gross income for 1967			3,000
Less: Charitable contributions made in 1967 to section 170(b)(1)(A) organizations			1,000
			2,000
Amount of excess contributions treated as paid in 1967—the lesser of $2,400 (available carryovers to 1967) or $2,000 (excess of 30 percent of adjusted gross income ($3,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($1,000))			2,000

1968

Contribution year	*Total excess*	*Less: Amount treated as paid in year prior to 1968*	*Available charitable contribution carryovers*
1964	$1,000	$1,000	0
1965	900	900	0
1966	500	100	$400
1967	0	0	0
			400
30 percent of B's adjusted gross income for 1968			2,700
Less: Charitable contributions made in 1968 to section 170(b)(1)(A) organizations			1,500
			1,200
Amount of excess contributions treated as paid in 1968—the lesser of $400 (available carryovers to 1968) or $1,200 (30 percent of adjusted gross income $2,700) over contributions actually made in 1968 to section 170(b)(1)(A) organizations ($1,500)			400

(3) *Effect of net operating loss carryback to contribution year.* The amount of the excess contribution for a contribution year (computed as provided in subparagraphs (1) and (5) 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 contributions made to organizations referred to in section 170(b)(1)(A) shall be limited to the amount of such contributions which did not exceed 30 percent of the donor's adjusted gross income (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the contribution year.

(4) *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 subparagraph (2) of 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 carryover to taxable years succeeding the deduction year, the amount of contributions made to organizations referred to in section 170(b)(1)(A) 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 30 percent of the donor's adjusted gross income (computed without regard to any net operating loss carryback or any of the modifications referred to in section 172(d)) for the deduction year.

(5) *Reduction 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(b)(5)(B) and this subparagraph in computing the excess described in subparagraph (1) of this paragraph 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 such subparagraph (1) 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 organizations specified in section 170(b)(1)(A) (see paragraph (b) of this section) and to organizations not so specified 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 not specified in section 170(b)(1)(A) may be deducted from such adjusted gross income. Thus, if the excess of the contributions made in the contribution year to organizations specified in section 170(b)(1)(A) 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 will 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 1964 has adjusted gross income (computed without regard to any net operating loss deduction) of $50,000. During 1964 he made charitable contributions in the amount of $20,000 all of which were to organizations specified in section 170(b)(1)(A). B has a net operating loss carryover from 1963 of $50,000. In the absence of the net operating loss deduction B would have been allowed a deduction for charitable contributions of $15,000. 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(b)(5)(B) and this subparagraph) a tentative excess charitable contribution of $20,000. For purposes of determining the net operating loss which remains to be carried over to 1965, B computes his taxable income for his prior taxable year, 1964, under section 172(b)(2) by deducting the $15,000 charitable contribution. After the $50,000 net operating loss carryover is applied against the $35,000 of taxable income for 1964 (computed in accordance with section 172(b)(2), assuming no deductions other than the charitable contribution deduction are applicable in making such computation), there remains a $15,000 net operating loss carryover to 1965. Since the application of the net operating loss carryover of $50,000 from 1963 reduces the 1964 adjusted gross income (for purposes of determining 1964 tax liability) to zero, no part of the $20,000 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 1965, 1966, 1967, 1968, 1969, the $20,000 must be reduced by the portion thereof ($15,000) which was used to reduce taxable income for 1964 (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 1965 from zero to $15,000.

Example 2. Assume the same facts as in *Example 1,* except that B's total contributions of $20,000 made during 1964 consisted of $15,000 to organizations specified in section 170(b)(1)(A) and $5,000 to organizations not so specified. Under these facts there is a tentative excess charitable contribution of $15,000, rather than $20,000 as in *Example 1.* For purposes of determining the net operating loss which remains to be carried over to 1965, B computes his taxable income for his prior taxable year, 1964, under section 172(b)(2) by deducting the $15,000 of charitable contributions made to organizations specified in section 170(b)(1)(A). Since the excess charitable contribution of $15,000 determined in accordance with subparagraph (1) of this paragraph was used to reduce taxable income for 1964 (as computed for purposes of the second sentence of section 172(b)(2)) and thereby served to increase the net operating loss carryover to 1965 from zero to $15,000, 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 1964 to organizations not specified in section 170(b)(1)(A).

(6) *Change in type of return filed*—(i) *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

subparagraphs (1) and (5) 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 subparagraphs (1) and (5) 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 subparagraph (2) of this paragraph as a charitable contribution paid to an organization specified in section 170(b)(1)(A) in the taxable year in which a separate return or separate returns are filed, each spouse shall for purposes of subparagraph (2) of this paragraph 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 subparagraph (1) of this paragraph. If such husband and wife make a joint return in one of the five taxable years immediately succeeding the contribution year with respect to which a joint excess charitable contribution is computed and following the first succeeding year in which such husband and wife filed a separate return or separate returns, 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 an organization specified in section 170(b)(1)(A) 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 (i) may be illustrated by the following example:

Example. H and W file joint returns for 1964, 1965, and 1966, and in 1967 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 1964:

1964

	H	*W*	*Joint return*
Adjusted gross income	$50,000	$40,000	$90,000
Contributions to section 170(b)(1)(A) organization (no other contributions)	27,000	20,000	47,000
Allowable charitable contribution deductions	15,000	12,000	27,000
Excess contributions for taxable year to be treated as paid in 5 succeeding taxable years	12,000	8,000	20,000

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 five succeeding taxable years. Assume that in 1965, the portion of such excess treated as paid by H and W is $3,000 and that in 1966, 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 1965) and $7,000 (amount treated as paid in 1966)). Since H and W file separate returns in 1967, $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 1964)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1964)×$10,000=$6,000

$8,000 (excess charitable contributions made by W (based on separate return computation) in 1964)/$20,000 (total excess charitable contributions made by H and W (based on separate return computation) in 1964)×$10,000=$4,000

In 1967 H has adjusted gross income of $70,000 and he contributes $14,000 to an organization specified in section 170(b)(1)(A). In 1967 W has adjusted gross income of $50,000, and she contributes $10,000 to an organization specified in section 170(b)(1)(A). H may claim a charitable contribution deduction of $20,000 in 1967, and W may claim a charitable contribution deduction of $14,000 in 1967. H's $20,000 deduction consists of the $14,000 contribution to the section 170(b)(1)(A) organization in 1967 and $6,000 carried over from 1964 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. W's $14,000 deduction consists of the $10,000 contribution made to a section 170(b)(1)(A) organization in 1967 and $4,000 carried over from 1964 and treated as a charitable contribution paid to a section 170(b)(1)(A) organization in 1967. The $6,000 contribution treated as paid in 1967 by H, and the $4,000 contribution treated as paid in 1967 by W are computed as follows:

	H	*W*
Available charitable contribution carryover (see computations above)	$6,000	$4,000
30-percent of adjusted gross income	21,000	15,000
Contributions made in 1967 to section 170(b)(1)(A) organization (no other contributions)	14,000	10,000
Amount of allowable deduction unused	7,000	5,000
Amount of excess contributions treated as paid in 1967—the lesser of $6,000 (available carryover of H to 1967) or $7,000 (excess of 30 percent of adjusted gross income ($21,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($14,000))	6,000	
The lesser of $4,000 (available carryover of W to 1967) or $5,000 (excess of 30 percent of adjusted gross income ($15,000) over contributions actually made in 1967 to section 170(b)(1)(A) organizations ($10,000))		4,000

(ii) *From separate returns to joint return and remarried taxpayers.* 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 subparagraphs (1) and (5) of this paragraph, and

(*b*) Such husband and wife make a joint return for one or more of the taxable years immediately 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 subparagraph (2) of this paragraph as a charitable contribution paid to an organization specified in section 170(b)(1)(A). The provisions of this subdivision are also applicable 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 five taxable years immediately 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 subparagraph (2) of this paragraph 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 1966 and W files a separate return for 1967. W made a joint return for herself and H for 1966. In that example, the unused excess charitable contribution as of January 1, 1967, 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 1967 or any subsequent year.

(7) *Information required in support of a deduction of an amount 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 subparagraph (2) of this paragraph, is treated (in whole or in part) as paid in such taxable year, the taxpayer shall attach to his return a statement showing:

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

(ii) The excess charitable contributions made in each contribution year,

(iii) The portion of such excess (or each such excess) treated as paid in accordance with subparagraph (2) of this paragraph in any taxable year intervening between the contribution year and the taxable year for which the return is made, and

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

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6605, 27 FR 8096, Aug. 15, 1962; T.D. 6639, 28 FR 1762, Feb. 26, 1963; T.D. 6732, 29 FR 6280, May 13, 1964; T.D. 6900, 31 FR 14634, Nov. 17, 1966; T.D. 7207, 37 FR 20768, Oct. 4, 1972; T.D. 7427, 41 FR 34026, Aug. 12, 1976]

§ 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 recordkeeping and return requirements in support of deductions for charitable contributions (whether by an itemizing or nonitemizing taxpayer) see § 1.170A–13. 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) Transfers of property to an organization described in section 170(c) which bear a direct relationship to the taxpayer's trade or business and which are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses rather than as charitable contributions. See section 162 and the regulations thereunder.

(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 § 1.170A–13(f)(6)) goods or services (as defined in § 1.170A–13(f)(5)) 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 the organization provides 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) *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.

(4) *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.

(5) *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) For charitable contributions paid by a citizen of the United States or a domestic corporation entitled to the benefits of section 931 (relating to income from sources within possessions of the United States), see section 931(d) and the regulations thereunder.

(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 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.

(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]

§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 8 1/2 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 5 1/2 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 62 1/2 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
(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:

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

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.

The term *section 170(b)(1)(A) organization* as used in the regulations under section 170 means any organization described in paragraphs (a) through (i) 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 in clauses (vii) and (viii))* as used in sections 507 and 509 of the Code and the regulations thereunder means one or more organizations described in paragraphs (a) through (e) of this section, except as modified by the regulations under part II of subchapter F of chapter I or under chapter 42.

(a) *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.

(b) *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.

(c) *Hospitals and medical research organizations*—(1) *Hospitals.* An organization (other than one described in subparagraph (2) of this paragraph) 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.

The term *hospital* includes (A) Federal hospitals and (B) 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 subdivision (i) of this subparagraph if its principal purpose or function is the providing of hospital or medical care. For purposes of this subdivision, 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 subdivision (i) of this subparagraph 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. 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 subdivision (i) of this subparagraph, 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, subparagraph (2) of this paragraph 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 subdivision. However, the requirement of continuous active conduct of medical research indicates that the type of organization contemplated in this subparagraph 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 subparagraph shall only apply with respect to such medical research organizations.

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

(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).

However, 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 subdivision (viii) of this subparagraph) 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 subdivision (iii) of this subparagraph. For the meaning of the term ''principal purpose or functions'' see subdivision (iv) of this subparagraph. For the meaning of the term ''primarily engaged directly in the continuous active conduct of medical research'' see subdivision (v) of this subparagraph. For the meaning of the term ''medical research in conjunction with a hospital'' see subdivision (vii) of this subparagraph.

(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, *e.g.*, 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 subparagraph. 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 subdivision even where its governing instrument so expressly provides. An organization that otherwise meets all of the requirements of this subparagraph (including this subdivision) 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 (c)(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.

(*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 earlier year and a lower percentage in 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 (c)(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 (c)(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 (c)(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, or 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 (c)(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 foundation 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 subdivision (ii) of this subparagraph), 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 subdivision 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 subdivisions (v) and (vii) of this subparagraph 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 subparagraph 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 subdivision (iv) of this subparagraph, 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 subdivision (iv) of this subparagraph, 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 consists 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 subdivision 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 subdivision 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 subdivision 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.

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

(e) *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 is:

(i) A corporation, trust, or community chest, fund, or foundation, referred to in section 170(c)(2) (other than an organization specifically described in paragraphs (a) through (d) of this section), and

(ii) A ''publicly supported'' organization.

For purposes of this paragraph, an organization is *publicly supported* if it 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. An organization will be treated as being ''public supported'' if it meets the requirements of either subparagraph (2) or subparagraph (3) of this paragraph. Types of organizations which, subject to the provisions of this paragraph, 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, and organizations such as the American Red Cross or the United Givers Fund.

(2) *Determination whether an organization is ''publicly supported''; 33⅓ percent-of-support test.* An organization will be treated as a ''publicly supported'' organization if the total amount of support which the organization ''normally'' (as defined in subparagraph (4) of this paragraph) 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 33 1/3 percent of the total support ''normally'' received by the organization. See subparagraphs (6), (7), and (8) of this paragraph for the definition of ''support.'' The application of this test is illustrated by *Example 1* of subparagraph (9) of this paragraph.

(3) *Determination whether an organization is ''publicly supported''; facts and circumstances test for organizations failing to meet 33 1/3 percent-of-support test.* Even if an organization fails to meet the 33 1/3 percent-of-support test described in subparagraph (2) of this

paragraph, it will be treated as a ''publicly supported'' organization if it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources, and meets the other requirements of this subparagraph. In order to satisfy this subparagraph, an organization must meet the requirements of subdivisions (i) and (ii) of this subparagraph in order to establish, under all the facts and circumstances, that it normally receives a substantial part of its support from governmental units or from direct or indirect contributions from the general public, and it must be in the nature of a ''publicly supported'' organization, taking into account the factors described in subdivisions (iii) through (vii) of this subparagraph. The requirements and factors referred to in the preceding sentence with respect to a ''publicly supported'' organization (other than one described in subparagraph (2) of this paragraph) are:

(i) *Ten percent-of-support limitation.* The percentage of support ''normally'' (as defined in subparagraph (4) of this paragraph) 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 subparagraph, 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. See subparagraphs (6), (7), and (8) of this paragraph for the definition of ''support.''

(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 (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 may, in its early years of existence, 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.

In addition to the requirements set forth in subdivisions (i) and (ii) of this subparagraph which 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 subparagraph (1) of this paragraph. However, an organization is not generally required to satisfy all of the factors in subdivisions (iii) through (vii) of this subparagraph. 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.

(iii) *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 subdivision (i) of this subparagraph from public or governmental sources, the lesser will be the burden of establishing the publicly supported nature of the organization through other factors described in this subparagraph, 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 compliance with this subdivision 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 compliance with the other factors described in this subparagraph.

(iv) *Sources of support.* The fact that an organization meets the requirement of subdivision (i) of this subparagraph 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 taken into consideration in determining whether an organization is ''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.

(v) *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 (G)) will be taken into account in determining whether an organization is ''publicly supported.'' An organization will be treated as meeting this requirement if it has a governing body (whether designated in the organization's governing instrument or bylaws as a Board of Directors, Board of Trustees, etc.) 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.

(vi) *Availability of public facilities or services; public participation in programs or policies.* (A) The fact that an organization is of the type which 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 and 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.''

(B) 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.''

(C) Similarly, the following factors will also be considered evidence that an organization is ''publicly supported:''

(*1*) 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;

(*2*) The maintenance of a definitive program by an organization to accomplish its charitable work in the community, such as slum clearance or developing employment opportunities; and

(*3*) 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.

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

(A) 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);

(B) 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; and

(C) 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 *Examples 2* through *5* contained in subparagraph (9) of this paragraph for illustrations of this subparagraph.

(4) *Definition of ''normally''; general rule*—(i) *Normally; one-third support test.* For purposes of subparagraph (2) of this paragraph, an organization will be considered as ''normally'' meeting the 33 1/3 percent-of-support test for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the organization meets the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph on an aggregate basis.

(ii) *Normally; facts and circumstances test.* For purposes of subparagraph (3) of this paragraph, an organization will be considered as ''normally'' meeting the requirements of subparagraph (3) of this paragraph for its current taxable year and the taxable year immediately succeeding its current year, if, for the 4 taxable years immediately preceding the current taxable year, the organization meets the requirements of subparagraph (3) (i) and (ii) of this paragraph on an aggregate basis and satisfies a sufficient combination of the factors set forth in subparagraph (3) (iii) through (vii) of this paragraph. In the case of subparagraph (3) (iii) and (iv) of this paragraph, facts pertinent to years preceding 4 taxable years immediately preceding the current taxable year may also be taken into consideration. The combination of factors set forth in subparagraph (3) (iii) through (vii) of this paragraph which an organization ''normally'' must meet does not have to be the same for each 4-year period so long as there exists a sufficient combination of factors to show compliance with subparagraph (3) of this paragraph.

(iii) *Special rule.* The fact that an organization has ''normally'' met the requirements of subparagraph (2) of this paragraph 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 requirements of subparagraph (3) of this paragraph for such succeeding taxable year.

(iv) *Illustration.* The application of subdivisions (i), (ii), and (iii) of this subparagraph may be illustrated by the following example:

Example X, an organization described in section 170(c)(2), meets the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph in taxable year 1975 on the basis of support received during taxable years 1971, 1972, 1973, and 1974. It therefore ''normally'' meets the requirements of subparagraph (2) of this paragraph for 1975 and 1976, the taxable year immediately succeeding 1975 (the current taxable year). For the taxable year 1976, X is unable to meet the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph on the basis of support received during taxable years 1972, 1973, 1974, and 1975. If X can meet the requirements of subparagraph (3) of this paragraph on the basis of taxable years 1972, 1973, 1974, and 1975, X will meet the requirements of subparagraph (3) of this paragraph for 1977 (the taxable year immediately succeeding 1976, the current taxable year) under subdivision (ii) of this subparagraph. However, if on the basis of both the taxable years 1972 through 1975 and 1973 through 1976, X, fails to meet the requirements of both subparagraphs (2) and (3) of this paragraph, X will not be described in section 170(b)(1)(A)(vi) for 1977. However, X will not be disqualified as a section 170(b)(1)(A)(vi) organization for taxable year 1976, because it ''normally'' met the requirements of subparagraph (2) of this paragraph on the basis of the taxable years 1971 through 1974, unless the provisions of subdivision (v) of this subparagraph become applicable.

(v) *Exception for material changes in sources of support*—(A) *In general.* If for the current taxable year there are substantial and material changes in an organization's sources of support other than changes arising from unusual grants excluded under subparagraph (6)(ii) of this paragraph, then in applying subparagraph (2) or (3) of this paragraph, neither the 4-year computation period applicable to such year as an immediately succeeding taxable year or as a current taxable year shall apply, and in lieu of such computation periods there shall be applied a computation period consisting of the taxable year of substantial and material changes and the 4 taxable years immediately preceding such year. Thus, for example, if there are substantial and material changes in an organization's sources of support for taxable year 1976, then even though such organization meets the requirements of subparagraph (2) or (3) of this paragraph based on a computation period of taxable years 1971–74 or 1972–75, such an organization will not meet the requirements of section 170(b)(1)(A)(vi) unless it meets the requirements of subparagraph (2) or (3) of this paragraph for a computation period consisting of the taxable years 1972–76. See *Example 3* in § 1.509(a)–3(c)(6) for an illustration of a similar rule. An example of a substantial and material change is the receipt of an unusually large contribution or bequest which does not qualify as an unusual grant under subparagraph (6)(ii) of this paragraph. See subparagraph (6)(iv)(*b*) of this paragraph as to the procedure for obtaining a ruling whether an unusually large grant may be excluded as an unusual grant.

(B) *Status of grantors and contributors.* If as a result of (*a*) of this subdivision, an organization is not able to meet the requirements of either the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph, or the facts and circumstances test described in subparagraph (3) of this paragraph for its current taxable year, its status (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) will not be affected until notice of change of status under section 170(b)(1)(A)(vi) is made to the public (such as by publication in the Internal Revenue Bulletin). The preceding sentence shall not apply, however, if the grantor or contributor was responsible for, or was aware of, the substantial and material change referred to in (*a*) of this subdivision, or 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)(vi) organization.

(C) *Reliance by grantors and 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 substantial and material change referred to in (*a*) of this subdivision, 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 4 preceding years, to assure a reasonably prudent man 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 organizations' founders, creators, or foundation managers, the procedure set forth in subparagraph (6)(iv)(*b*) of this paragraph may be followed by the grantee organization for the protection of the grantor or contributor.

(vi) *Special rule for new organizations.* If an organization has been in existence for at least 1 taxable year consisting of at least 8 months, but for fewer than 5 taxable years, the number of years for which the organization has been in existence immediately preceding each current taxable year being tested will be substituted for the 4-year period described in subdivision (i) or (ii) of this

subparagraph to determine whether the organization ''normally'' meets the requirements of subparagraph (2) or (3) of this paragraph. However, if subdivision (v)(*a*) of this subparagraph applies, then the period consisting of the number of years for which the organization has been in existence (up to and including the current year) will be substituted for the 4-year period described in subdivision (i) or (ii) of this subparagraph. An organization which has been in existence for at least 1 taxable year, consisting of 8 or more months, may be issued a ruling or determination letter if it ''normally'' meets the requirements of subparagraph (2) or (3) of this paragraph for the number of years described in this subdivision. Such an organization may apply for a ruling or determination letter under the provisions of this subparagraph, rather than under the provisions of subparagraph (5) of this paragraph. The issuance of a ruling or determination letter will be discretionary with the Commissioner. See subparagraph (5)(v) of this paragraph as to the initial determination of the status of a newly created organization. This subdivision shall not apply to those organizations receiving an extended advance ruling under subparagraph (5)(iv) of this paragraph.

(vii) *Special rule for organizations with existing ruling.* This subdivision 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 publicly supported organization described in section 170(b)(1)(A)(vi) and with respect to which the facts and circumstances on which the ruling was based have not substantially changed. An organization to which this subdivision applies shall be treated as an or ganization described in section 170(b)(1)(A)(vi) for a period not ending prior to 90 days after December 29, 1972. 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 subdivision applies will not be affected until notice of change of status under section 170(b)(1)(A)(vi) 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)(vi) organization.

(viii) *Termination of status.* For the transitional rules applicable to an organization that is unable to meet the requirements of this paragraph for its first taxable year beginning after December 31, 1969 (as extended by § 1.507–2(j)) and wishes to terminate its private foundation status, see § 1.507–2(c)(2) and (3).

(ix) *Status of ruling.* The provisions of this subparagraph do not require an organization to file a new application with the Internal Revenue Service every 2 years in order to maintain or reaffirm its status as a ''publicly supported'' organization described in section 170(b)(1)(A)(vi).

(5) *Advance rulings to newly created organizations*—(i) *In general.* A ruling or determination letter that an organization is described in section 170 (b)(1)(A)(vi) will not be issued to a newly created organization prior to the close of its first taxable year consisting of at least 8 months. However, such organization may request a ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for its first 2 taxable years (or its first 3 taxable years, if its first taxable year consists of less than 8 months). For purposes of this section, such 2- or 3-year period, whichever is applicable, shall be referred to as the advance ruling period. Such an advance ruling or determination letter may be issued if the organization can reasonably be expected to meet the requirements of subparagraph (2) or (3) of this paragraph during the advance ruling period. The issuance of a ruling or determination letter will be discretionary with the Commissioner.

(ii) *Basic consideration.* In determining whether an organization can reasonably be expected (within the meaning of subdivision (i) of this subparagraph) to meet the requirements of subparagraph (2) or (3) of this paragraph for its advance ruling period or

extended advance ruling period as provided in subdivision (iv) of this subparagraph, if applicable, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. The information to be considered for this purpose shall consist of all pertinent facts and circumstances relating to the requirements set forth in subparagraph (3) of this paragraph.

(iii) *Status of newly created organizations*—(A) *Advance ruling.* This subdivision shall apply to a newly created organization which has received an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, that it will be treated as a section 170(b)(1)(A)(vi) organization for its advance or extended advance ruling period. So long as such an organization's ruling or determination letter has not been terminated by the Commissioner before the expiration of the advance or extended advance ruling period, then whether or not such organization has satisfied the requirements of subparagraph (2) or (3) of this paragraph during such advance or extended advance ruling period, such an organization will be treated as an organization described in section 170(b)(1)(A)(vi) in accordance with (*b*) and (*c*) of this subdivision, both for purposes of the organization and any grantor or contributor to such organization.

(B) *Reliance period.* Except as provided in (*a*) and (*c*) of this subdivision, an organization described in (*a)* of this subdivision will be treated as an organization described in section 170(b)(1)(A)(vi) for all purposes other than sections 507(d) and 4940 for the period beginning with its inception and ending 90 days after its advance or extended advance ruling period. Such period will be extended until a final determination is made of such an organization's status only if the organization submits, within the 90-day period, information needed to determine whether it meets the requirements of subparagraph (2) or (3) of this paragraph for its advance or extended advance ruling period (even if such organization fails to meet the requirements of such subparagraph (2) or (3)). However, since this subparagraph does not apply to the tax imposed by section 4940, if it is subsequently determined that the organization was a private foundation from its inception, then the tax imposed by section 4940 shall be due without regard to the advance or extended advance ruling or determination letter. Consequently, if any amount of tax under section 4940 in such a case is not paid on or before the last date prescribed for payment, the organization is liable for interest in accordance with section 6601. However, since any failure to pay such tax during the period referred to in this subparagraph is due to reasonable cause, the penalty under section 6651 with respect to the tax imposed by section 4940 shall not apply.

(C) *Grantors or contributors.* If a ruling or determination letter is terminated by the Commissioner prior to the expiration of the period described in (b) of this subdivision, for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, the status of grants or contributions with respect to grantors or contributors to such organizations will not be affected until notice of change of status of such organization is made to the public (such as by publication of the Internal Revenue Bulletin). The preceding sentence shall not apply however, 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 Internal Revenue Service had given notice to such organization that it would be deleted from such classification. Prior to the making of any grant or contribution which allegedly will not result in the grantee's loss of classification under section 170(b)(1)(A)(vi), a potential grantee organization may request a ruling whether such grant or contribution may be made without such loss of classification. A request for such ruling may be filed by the grantee organization with the district director. The issuance of

such ruling 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 subparagraph (6)(iii) of this paragraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subparagraph (6)(ii) of this paragraph.

(iv) *Extension of advance ruling period.* (A) The advance ruling period described in subdivision (i) of this subparagraph shall be extended for a period of 3 taxable years after the close of the unextended advance ruling period if the organization so requests, but only if such organization's request accompanies its request for an advance ruling and is filed with a consent under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for any taxable year within the extended advance ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for the last taxable year within the extended advance ruling period. An organization's extended advance ruling period is 5 taxable years if its first taxable year consists of at least 8 months, or is 6 years if its first taxable year is less than 8 months.

(B) *Notwithstanding* (*a*) of this subdivision, an organization which has received or applied for an advance ruling prior to January 29, 1973, may file its request for the 3-year extension within 90 days from such date, but only if it files the consents required in this section.

(C) See subdivision (v) of this subparagraph for the effect upon the initial determination of status of an organization which receives a ruling for an extended advance ruling period.

(v) *Initial determination of status.* (A) The initial determination of status of a newly created organization is the first determination (other than by issuance of an advance ruling or determination letter under subdivision (i) of this subparagraph or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph) that the organization will be considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph for a period beginning with its first taxable year.

(B) In the case of a new organization whose first taxable year is at least 8 months, except as provided for in subdivision (v)(*d*) of this subparagraph, the initial determination of status shall be based on a computation period of either the first taxable year or the first and second taxable years.

(C) In the case of a new organization whose first taxable year is less than 8 taxable months, except as provided for in subdivision (v)(*d*) of this subparagraph, the initial determination of status shall be based on a computation period of either the first and second taxable years or the first, second, and third taxable years.

(D) In the case of an organization which has received a ruling or determination letter for an extended advance ruling period under subdivision (iv) of this subparagraph, the initial determination of status shall be based on a computation period of all of the taxable years in the extended advance ruling period. However, where the ruling or determination letter for an extended advance ruling period under subdivision (iv) of this subparagraph is terminated by the Commissioner prior to the expiration of the relevant period described in subdivision (iii)(*b*) of this subparagraph, the initial determination of status shall be based on a computation period of the period provided in (*b*) or (*c*) of this subdivision or, if greater, the number of years to which the advance ruling applies.

(E) An initial determination that an organization will be considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph shall be effective for each taxable year in the computation period plus (except as provided by subparagraph (4)(v)(*a*) of this paragraph, relating to material changes in sources of support) the 2 taxable years immediately succeeding the computation period. Therefore, in the case of an organization referred to in (*b*) of this subdivision to which subparagraph

(4)(v)(*a*) of this paragraph does not apply, with respect to its first, second, and third taxable years, such an organization shall be described in section 170(b)(1)(A)(vi) if it meets the requirements of subparagraph (2) or (3) of this paragraph for either its first taxable year or for its first and second taxable years on an aggregate basis. In addition, if it meets the requirements of subparagraph (2) or (3) of this paragraph for its first and second taxable years, it shall be described in section 170(b)(1)(A)(vi) for its fourth taxable year. Once an organization is considered as ''normally'' meeting the requirements of subparagraph (2) or (3) of this paragraph for a period specified under this subdivision, subparagraph (4) (i), (ii), (v), or (vi) of this paragraph shall apply.

(F) The provisions of this subdivision may be illustrated by the following examples:

Example 1. X, a calendar year organization described in section 501(c)(3), is created in February 1972. The support received from the public in 1972 by X will satisfy the one-third support test described in subparagraph (4)(i) of this paragraph over its first taxable year, 1972. X may therefore get an initial determination that it meets the requirements of subparagraph (2) of this paragraph for its first taxable year beginning in February 1972 and ending on December 31, 1972. This determination will be effective for taxable years 1972, 1973, and 1974.

Example 2. Assume the same facts as in *Example 1* except that X also receives a substantial contribution from one individual in 1972 which is not excluded from the denominator of the one-third support fraction described in subparagraph (4)(i) of this paragraph by reason of the unusual grant provision of subparagraph (6)(ii) of this paragraph. Because of this substantial contribution, X fails to satisfy the one-third support test over its first taxable year, 1972. X also fails to satisfy the ''facts and circumstances'' test described in subparagraph (4)(ii) of this paragraph for its first taxable year, 1972. However, the support received from the public over X's first and second taxable years in the aggregate will satisfy the one-third support test. X may therefore get an initial determination that it meets the requirements of subparagraph (2) of this paragraph for its first and second taxable years in the aggregate beginning in February 1972 and ending on December 31, 1973. This determination will be effective for taxable years 1972, 1973, 1974, and 1975.

Example 3. Y, a calendar year organization described in section 501(c)(3), is created in July 1972. Y requests and receives an extended advance ruling period of 5 full taxable years plus its initial short taxable year of 6 months under subparagraph (5)(iv) of this paragraph. The extended advance ruling period begins in July 1972 and ends on December 31, 1977. The support received from the public over Y's first through sixth taxable years in the aggregate will satisfy the one-third support test described in subparagraph (4)(i) of this paragraph. Therefore, Y in 1978 may get an initial determination that it meets the requirements of subparagraph (2) of this paragraph in the aggregate over all the taxable years in its extended advance ruling period beginning in July 1972 and ending on December 31, 1977. This determination will be effective for taxable years 1972 through 1979.

Example 4. Assume the same facts as in *Example 3* except that the ruling for the extended advance ruling period is terminated prospectively at the end of 1975, so that Y may not rely upon such ruling for 1976 or any succeeding year. The support received from the public over Y's first through fourth taxable years (1972 through 1975) will not satisfy either the one-third support test described in subparagraph (4)(i) of this paragraph, or the ''facts and circumstances'' test described in subparagraph (4)(ii) of this paragraph. Because the ruling was terminated the computation period for Y's initial determination of status is the period 1972 through 1975. Since Y has not met the requirements of either subparagraph (2) or (3) of this paragraph for such computation period, Y is not described in section 170(b)(1)(A)(vi) for purposes of its initial determination of status. If Y is not described in section 170(b)(1)(A) (i) through (v) or section 509(a) (2), (3), or (4), then Y is a private foundation. As of 1976, Y shall be treated as a private foundation for all purposes (except as provided in subdivision (iii)(*c*) of this subparagraph with respect to grantors and contributors), and as of July 1972 for purposes of the tax imposed by section 4940 and for purposes of section 507(d) (relating to aggregate tax benefit).

(vi) *Failure to obtain advance ruling.* (A) Unless a newly created organization has obtained an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, that it will be treated as a section 170(b)(1)(A)(vi) organization for its advance or extended advance ruling period, it cannot rely upon the possibility it will meet the requirements of subparagraph (2) or (3) of this paragraph

for a taxable year which begins before the close of either applicable computation period provided for in subdivision (v) (*b*) or (*c*) of this subparagraph. Therefore, such an organization, in order to avoid the risk of subsequently being determined to be a private foundation because of failure to qualify under section 170(b)(1)(A)(vi) and therefore under section 509(a)(1), may comply with the rules applicable to private foundations and may pay, for example, the tax imposed by section 4940. In that event, if the organization subsequently meets the requirements of subparagraph (2) or (3) of this paragraph for either applicable computation period, it shall be treated as a section 170(b)(1)(A)(vi) organization from its inception and, therefore, any tax imposed under chapter 42 shall be refunded and section 509(b) shall not apply.

(B) If a newly created organization fails to obtain an advance ruling or determination letter under subdivision (i) of this subparagraph, or an extended advance ruling or determination letter under subdivision (iv) of this subparagraph, and fails to meet the requirements of subparagraph (2) or (3) of this paragraph for the first applicable computation period provided for in subdivision (v) (*b*) or (*c*) of this subparagraph, see section 6651 for penalty for failure to file return and pay tax.

(6) *Definition of support; meaning of general public*—(i) *In general.* In determining whether the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph or the 10 percent-of-support limitation described in subparagraph (3)(i) of this paragraph is ''normally'' 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 subparagraph (4) (i), (ii), (v), or (vi) or (5)(v) of this paragraph does not exceed 2 percent of the organization's total support for such period, except as provided in subdivision (ii) of this subparagraph. Therefore, any contribution by one individual will be included in full in the denominator of the fraction determining the 33 1/3 percent-of-support or the 10 percent-of-support limitation, but will only be includible in the numerator of such fraction to the extent that such amount does not exceed 2 percent of the denominator. In applying the 2 percent limitation, all contributions made by a donor and by any person or persons standing in a relationship to the donor which is described in section 4946(a)(1) (C) through (G) and the regulations thereunder shall be treated as made by one person. The 2 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 subdivision (v) of this subparagraph. For purposes of subparagraphs (2), (3)(i) and (7)(ii)(*b*) of this paragraph, 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) which normally receive a substantial part of their support from direct contributions from the general public, except as provided in subdivision (v) of this subparagraph. See the examples in subparagraph (9) of this paragraph for the application of this subdivision. For purposes of this paragraph (e), 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.* For purposes of applying the 2 percent limitation described in subdivision (i) of this subparagraph to determine whether the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph or the 10 percent-of-support limitation in subparagraph (3)(i) of this paragraph is satisfied, one or more contributions may be excluded from both the numerator and the denominator of the applicable percent-of-support fraction if such contributions meet the requirements of subdivision (iii) of this subparagraph. The exclusion provided by this subdivision is generally intended to apply to substantial contributions or bequests from disinterested parties which contributions or bequests:

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

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

(C) Would, by reason of their size, adversely affect the status of the organization as normally being publicly supported for the applicable period described in subparagraph (4) or (5) of this paragraph.

In the case of a grant (as defined in § 1.509(a)–3(g)) which meets the requirements of this subdivision, if the terms of the granting instrument (whether executed before or after 1969) require that the funds be paid to the recipient organization over a period of years, the amount received by the organization each year pursuant to the terms of such grant may be excluded for such year. However, no item of gross investment income may be excluded under this subparagraph. The provisions of this subparagraph shall apply to exclude unusual grants made during any of the applicable periods described in subparagraph (4), (5), or (6) of this paragraph. See subdivision (iv) of this subparagraph as to reliance by a grantee organization upon an unusual grant ruling under this subparagraph.

(iii) *Determining factors.* In determining whether a particular contribution may be excluded under subdivision (ii) of this subparagraph 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.* (A) As to the status of grants and contributions which result in substantial and material changes in the organization (as described in subparagraph (4)(v)(*a*) of this paragraph) and which fail to meet the requirements for exclusion under subdivision (ii) of this subparagraph, see the rules prescribed in subparagraph (4)(v) (*b*) and (*c*) of this paragraph.

(B) Prior to the making of any grant or contribution which will allegedly meet the requirements for exclusion under subdivision (ii) of this subparagraph, a potential grantee organization may request a ruling whether such grant or contribution may be so excluded. Requests for such ruling may be filed by the grantee organization with the district director. The issuance of such ruling 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 subdivision (iii) of this subparagraph. If a favorable ruling is issued, such ruling may be relied upon by the grantor or contributor of the particular contribution in question for purposes of sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 and by the grantee organization for purposes of subdivision (ii) of this subparagraph.

(v) *Grants from public charities.* Pursuant to subdivision (i) of this subparagraph, contributions received from a governmental unit or from a section 170(b)(1)(A)(vi) organization are not subject to the 2 percent limitation described in that subdivision 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 subdivision.

(7) *Definition of support; special rules and meaning of terms*—(i) *Definition of support.* For purposes of this paragraph, 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.

For purposes of the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph and the 10 percent-of-support limitation in subparagraph (3)(i)

of this paragraph, all amounts received which are described in (*a*) or (*b*) of this division are to be excluded from both the numerator and the denominator of the fractions determining compliance with such tests, except as provided in subdivision (ii) of this subparagraph.

(ii) *Organizations dependent primarily on gross receipts from related activities.* Notwithstanding the provisions of subdivision (i) of this subparagraph, an organization will not be treated as satisfying the 33 1/3 percent-of-support test in subparagraph (2) of this paragraph or the 10 percent-of-support limitation in subparagraph (3)(i) of this paragraph if it receives:

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

(B) An insignificant amount of its support from governmental units (without regard to amounts referred to in subdivision (i)(*a*) of this subparagraph) and contributions made directly or indirectly by the general public.

For example X, an organization described in section 501(c)(3), is controlled by A, its president. X received $500,000 during the 4 taxable years immediately preceding its current taxable year under a contract with the Department of Transportation, pursuant to which X 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 X consisted of $5,000 in small contributions primarily from X's employees and business associates. The $500,000 amount constitutes support under section 509(d)(2) and 509(d)(2)(*a*) of this subdivision. Under these circumstances, X meets the conditions of (*a*) and (*b*) of this subdivision and will not be treated as meeting the requirements of either subparagraph (2) or subparagraph (3) of this paragraph. As to the rules applicable to organizations which fail to qualify under section 170(b)(1)(A)(vi) because of the provisions of this subdivision, see section 509(a)(2) and the regulations thereunder. 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).

(iii) *Membership fees.* For purposes of this subparagraph, 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).

(8) *Support from a governmental unit.* (i) For purposes of subparagraphs (2) and (3)(i) of this paragraph, 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 subparagraph (7)(i)(*a*) of this paragraph.

(ii) For purposes of subdivision (i) of this subparagraph, 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 subparagraph (7)(i)(*a*) of this paragraph) 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 subdivision, rather than an amount described in subparagraph (7)(i)(*a*) of this paragraph.

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

Example 1. (a) M is an organization referred to in section 170(c)(2). For the years 1970 through 1973 (the applicable period with respect to the taxable year 1974 under subparagraph (4) of this paragraph), M received support (as defined in subparagraphs (6) through (8) of this paragraph) of $600,000 from the following sources:

Investment income	$300,000
City Y (a governmental unit referred to in section 170(c)(1))	40,000
United Fund (an organization referred to in section 170(b)(1)(A)(vi)	40,000
Contributions	220,000
Total support	600,000

(b) With respect to the taxable year 1974, M ''normally'' received in excess of 33 1/3 percent of its support from a governmental unit referred to in section 170(c)(1) and from direct and indirect contributions from the general public (as defined in subparagraph (6) of this paragraph) computed as follows:

33⅓ percent of total support	$200,000
Support from a governmental unit referred to in section 170(c)(1)	40,000
Indirect contributions from the general public (United Fund)	40,000
Contributions by various donors (no one having made contributions which total in excess of $12,000—2 percent of total support)	50,000
Six contributions (each in excess of $12,000—2 percent total support) 6×$12,000	72,000
	202,000

(c) Since the amount of X's support from governmental units referred to in section 170(c)(1) and from direct and indirect contributions from the general public with respect to the taxable year 1974 ''normally'' exceeds 33 1/3 percent of M's total support for the applicable period (1970–73), X meets the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph and is therefore treated as satisfying the requirements for classification as a ''publicly supported'' organization under subparagraph (2) of this paragraph for the taxable years 1974 and 1975 (there being no substantial and material changes in the organization's character, purposes, methods of operation, or sources of support in these years).

Example 2. N is an organization referred to in section 170(c)(2). 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 4 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 which 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 4-year period in question, these fees from the general public constituted the remaining 5 percent of the organization's total support for such period. Under these circumstances, N does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph for its current taxable year. Furthermore, since only 5 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-of-support limitation described in subparagraph (3)(i) of this paragraph and cannot therefore be classified as ''publicly supported'' under subparagraph (3) of this paragraph. For its current taxable year, N therefore, is not an organization described in section 170(b)(1)(A)(vi). Since N has failed to satisfy the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph, none of the other requirements or factors set forth in subparagraph (3) (iii) through (vii) of this paragraph can be considered in determining whether N qualifies as a ''publicly supported'' organization.

Example 3. (a) O, an art museum, is an organization referred to in section 170(c)(2). In 1930, O was founded in Y 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 which 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 Y City from a variety of professions and occupations who represent the interests and views of the people of Y 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 each of its 4 most recent taxable years has received total contributions (in small sums of less than $100, none of which exceeds 2 percent of O's total support for such period) in excess of $10,000. These contributions from the general public (as defined in subparagraph (6) of this paragraph) represent 25 percent of the organization's total support for such 4-year period. For this same period, investment income from several large endowment funds has constituted 75 percent of its 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 Y City and elsewhere) have visited the museum in each of its four most recent taxable years.

(b) Under these circumstances, O does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph for its current year since it has received only 25 percent of its total support for the applicable 4-year period from the general public. However, under the facts set forth above, O has met the 10 percent-of-support limitation under subparagraph (3)(i), as well as the requirements of subparagraph (3)(ii), of this paragraph. Under all of the facts set forth in this example, O is considered as meeting the requirements of subparagraph (3) of this paragraph on the basis of satisfying subparagraph (3) (i) and (ii) of this paragraph and the factors set forth in subparagraph (3) (iii), (iv), (v), and (vi) of this paragraph, and is therefore classified as a ''publicly supported organization'' under subparagraph (1) of this paragraph for its current taxable year and the immediately succeeding taxable year (there being no substantial and material changes in the organization's character, purposes, methods of operation, or sources of support in these years).

Example 4. (a) In 1960, the P Philharmonic Orchestra was organized in Z 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 an organization referred to in section 170(c)(2). 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 charge is made for each of these performances. In addition, several performances are staged annually without charge. During its 4 most recent taxable years, 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 Z Community Chest, a public federated fundraising organization operating in Z 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 the Board and represent the interests and views of the community in the activities carried on by P.

(b) With respect to P's current taxable year, P's sources of support are computed on the basis of the 4 immediately preceding years, as follows:

Contributions	$520,000
Receipts from performances	100,000
Total support	620,000
Less:	
Receipts from performances (excluded under subparagraph (7)(i)(*a*) of this paragraph)	100,000
Total support for purposes of subparagraphs (2) and (3)(i) of this paragraph	520,000

(c) For purposes of subparagraphs (2) and (3)(i) of this paragraph, P's support is computed as follows:

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

(d) P's support from the general public, directly and indirectly, does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph ($140,800/$520,000=27 percent of total support). However, since P receives 27 percent of its total support from the general public, it meets the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph. P also meets the requirements of subparagraph (3)(ii) of this paragraph. As a result of satisfying these requirements and the factors set forth in subparagraph (3) (iii), (iv), (v), and (vi) of this paragraph, P is considered as meeting the requirements of subparagraph (3) of this paragraph and is therefore considered to be a ''publicly supported'' organization under subparagraph (1) of this paragraph.

(e) If, instead of the above facts, P were a newly created organization, P could obtain a

ruling pursuant to subparagraph (5) of this paragraph by reason of its purposes, organizational structure and proposed method of operation. Even if P had initially been founded by the contributions of a few individuals, such fact would not, in and of itself, disqualify P from receiving a ruling under subparagraph (5) of this paragraph.

Example 5. (a) Q is an organization referred to in section 170(c)(2). It is a philanthropic organization founded in 1965 by A for the purpose of making annual contributions to worthy charities. A created Q as a charitable trust by the transfer of $500,000 worth of appreciated securities to Q.

Pursuant to the trust agreement, A and two other members of his family are the sole trustees and are vested with the right to appoint successor trustees. In each of its four most recent taxable years, Q received $15,000 in investment income from its original endowment. Each year Q makes a solicitation for funds by operating a charity ball at A's residence. Guests are invited and requested to make contributions of $100 per couple. During the 4-year period involved, $15,000 was received from the proceeds of these events. A and his family have also made contributions to Q of $25,000 over the course of the organization's 4 most recent taxable years. Q makes disbursements each year of substantially all of its net income to the public charities chosen by the trustees.

(b) With respect to Q's current taxable year, Q's sources of support are computed on the basis of the 4 immediately preceding years as follows:

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

(c) For purposes of subparagraphs (2) and (3)(i) of this paragraph, Q's support is computed as follows:

Contributions from the general public	$15,000
One contribution (in excess of $2,000—2 percent of total support) 1×$2,000	2,000
Total	17,000

(d) Q's support from the general public does not meet the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph ($17,000/$100,000=17 percent of total support). Thus, Q's classification as a ''publicly supported'' organization depends on whether it meets the requirements of subparagraph (3) of this paragraph. Even though it satisfies the 10 percent-of-support limitation under subparagraph (3)(i) of this paragraph, its method of solicitation makes it questionable whether Q satisfies the requirements of subparagraph (3)(ii) of this paragraph. Because of its method of operating, Q also has a greater burden of establishing its publicly supported nature under subparagraph (3)(iii) of this paragraph. Based upon the foregoing and upon Q's failure to receive favorable consideration under the factors set forth in subparagraph (3) (iv), (v), and (vi) of this paragraph, Q does not satisfy the requirements of subparagraph (3) of this paragraph as a ''publicly supported'' organization.

(e) If, instead of the above facts, Q were a newly created organization, Q would not be able to receive a ruling pursuant to subparagraph (5) of this paragraph. Its purposes, organizational structure, and method of operation would be insufficient to establish that Q could reasonably be expected to meet the requirements of subparagraph (2) or (3) of this paragraph for its first 2 or its first 5 taxable years.

(10) *Community trusts; 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 33 1/3 percent-of-support test of paragraph (e)(2) of this section, 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 of paragraph (e)(3) of this section. Such facts and circumstances test includes a requirement of attraction of public support in paragraph (e)(3)(ii) of this section which, as applied to community trusts will generally 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 which call attention to the community trust as a potential recipient of gifts and berquests made for the benefit of the community or area served. A community trust is not required to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in

a manner similiar to campaigns conducted by a community chest or united fund. Paragraph (e) (12) and (13) of this section provide a transitional ruling period for certain community trusts in existence before November 11, 1976 that had irregular public support, so that they can meet the requirements of paragraph (e) (2) or (3) of this section based on the 4-year computation period described in paragraph (e)(4) of this section. Paragraph (e)(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 (e)(14) of this section contains rules for trusts or funds which are prevented from qualifying as component parts of a community trust by paragraph (e)(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 paragraph (e)(11) (iii) through (iv) 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 (e)(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 paragraph (e)(11) of this section (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 paragraph (e)(11) of this section; 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)(8) with respect to the transferred assets.

For purposes of paragraph (e)(11)(ii)(B) of this section, if the transferor is not a private foundation, the provisions of §1.507–2(a)(8) 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 paragraph (e)(11)(ii) of this section will be treated as a transfer made ''to'' a ''publicly supported'' community trust for purposes of section 170(b)(1)(A) and 507(b)(1)(A) if such community trust meets the requirements of section 170(b)(10(A)(vi) as a ''publicly supported'' organization at the time of the transfer, except as provided in §1.170A–9(e)(4)(v)(*b*) or §1.508–1(b) (4) and (6) (relating, generally, to reliance by grantors and contributors). See, also, paragraph (e)(14) (ii) and (iii) of this section for special provisions relating to split-interest trusts and certain private foundations described in section 170(b)(1)(E)(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 endoment fund to support charitable activities (within the meaning of section 170(c)(1) or (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 paragraph (e)(11)(iv) of this section. 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 such paragraph (e)(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 (2)(B)).

For purposes of this (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.* Except as provided in paragraph (e)(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 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 (e)(11)(v)(F) of this section) over a reasonable period of time (as determined by the governing body).

The fact that the exercise of any such power in paragraph (e)(11)(v)(B) (*1*), (*2*) or (*3*) of this section is reviewable by an appropriate State authority will not preclude the community trust from meeting the requirements of paragraph (e)(11)(v)(B) of this section.

(C) *Transitional rule.* (*1*) Notwithstanding paragraph (e)(11)(v)(B) of this section, if a community trust meets the requirements of paragraph (e)(11)(v)(C)(*2*) 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.

The necessity for the governing body to obtain the approval of a participating trustee to exercise such a power 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.

(*2*) Paragraph (e)(11)(v)(C)(*1*) of this section shall not apply unless the community trust meets the requirements of paragraph (e)(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 (e)(11)(v)(C)(*1*), 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 such paragraph (e)(11)(v)(B).

(D) *Inconsistent State law. (E T='03'≤1)* For purposes of paragraph (e)(11)(v)(B)

(*1*), (*2*), or (*3* or (C)(*1*) (*i*) or (*ii*) or (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 (e)(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 (e)(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 paragraph (e)(11)(v) (B), (C) and (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 paragraph (e)(11)(v) (B), (C), (D) or (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 (within the meaning of paragraph (e)(13)(x) of this section) 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 Internal Revenue Service will examine carefully whether the governing body has, in fact, committed itself to take the appropriate steps.

(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.

(vii) *Transitional rule.* If the governing instrument of a community trust (or an instrument of transfer) is inconsistent with the requirements of paragraph (e)(11) (iv) or (v) of this section but with respect to gifts or bequests acquired before January 1, 1982, the community trust changes its governing instrument (or instrument of

transfer) by the later of November 11, 1977, or one year after the gift or bequest is acquired, in order to conform such instruments to such provisions, then such an instrument shall be treated as consistent with paragraph (e)(11)(iv) or (v) of this section for taxable years beginning after December 31, 1969. In addition, if prior to the later of such dates, the organization has instituted court proceedings in order to conform such an instrument, then it may apply (prior to the later of such dates) for an extension of the period to conform such instrument to such provisions. Such application shall be made to the Commissioner of Internal Revenue, Attention: E:EO, Washington, DC 20224. The Commissioner, at the Commissioner's discretion, may grant such an extension, if in the Commissioner's opinion such a change will conform the instrument to such provisions and will be made within a reasonable time.

(12) *Community trusts qualifying for 5-year transitional ruling period*—(i) *In general.* Paragraph (e) (12) and (13) of this section contain transitional rules for certain community trusts in existence before November 11, 1976 which are unable to meet the requirements of paragraph (e) (2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. A community trust that satisfies the requirements of paragraph (e)(12)(ii) of this section will be eligible for a transitional ruling or determination letter that it will be treated as a section 170(b)(1)(A)(vi) organization for a 5-year transitional ruling period (referred to in this section as ''transitional ruling or determination letter''). These transitional rules apply to:

(A) A community trust which has been in existence less than 9 taxable years before November 11, 1976; and

(B) Other community trusts that for each taxable year beginning after December 31, 1969, and before January 1, 1978, qualify as ''publicly supported'' under paragraph (e) (2) or (3) of this section based upon a computation period of either:

(*1*) 10 taxable years, or

(*2*) The number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

For special rules in applying the requirements of paragraph (e) (2) or (3) of this section based upon such computation periods, see paragraph (e)(12)(v) of this section. For purposes of paragraph (e)(12) of this section the initial taxable year of the 5-year transitional ruling period (hereinafter referred to as the ''transitional ruling period'') shall be the organization's taxable year beginning in 1977, and (unless terminated earlier) the last year of the transitional ruling period is the organization's taxable year which begins in 1981.

(ii) *Transitional 5-year ruling.* (A) If a community trust meets the requirements of paragraph (e) (11), (12) and (13) of this section and can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section:

(*1*) For each of its taxable years (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 and 1981 based upon a 10-year computation period, and

(*2*) For its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section;

it may, at the discretion of the Commissioner, receive a transitional ruling or determination letter for the transitional ruling period.

(B)(*1*) However, if for the taxable year beginning in 1977, a community trust can meet the requirements of paragraph (e)(12)(i)(B) of this section only by using the computation period of its existence described in paragraph (e)(12)(i)(B)(*2*) of this section, then the community trust may meet the requirements of paragraph (e)(12)(ii)(A)(*1*) of this section if it is reasonably expected to meet the requirements of paragraph (e) (2) or (3) of this section for each of its taxable years beginning in 1978, 1979, 1980 and 1981 based upon a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization was in existence.

(*2*) In the case of a community trust that will not have been in existence more than ten taxable years as of its taxable year beginning in 1981, a transitional ruling or determination letter for the transitional ruling period will

not be granted unless the community trust can reasonably be expected to meet the requirements of paragraph (e)(2) or (3) of this section for its taxable year beginning in 1982 based upon a 4-year computation period under paragraph (e)(4) of this section and also a computation period consisting of the taxable years the organization has been in existence (other than the organization's taxable year beginning in 1982).

(C) A community trust that is eligible for a transitional ruling or determination letter must apply with the district director for such ruling or determination letter within one year after November 11, 1976. A transitional ruling or determination letter will be granted only if the requesting organization files with its request for such ruling or determination letter a consent letter under section 6501(c)(4) to the effect that the period of limitation upon assessment under section 4940 for all taxable years beginning before January 1, 1982 during the transitional ruling period shall not expire prior to 1 year after the date of the expiration of the time prescribed by law for the assessment of a deficiency for its taxable year beginning in 1981. The provisions of paragraph (e)(5)(iii) of this section (relating to reliance upon ruling) shall apply with respect to a community trust which receives a transitional ruling or determination letter and with respect to its grantors and contributors, expect that the transitional ruling period described in paragraph (e)(12)(ii) of this section shall be substituted for the advance ruling period described in paragraph (e)(5) (i) or (iv) of this section.

(D) A community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for a transitional ruling or determination letter or for any taxable year beginning after the expiration or termination of its transitional ruling or determination letter. In applying paragraph (e)(13) of this section to organizations applying for a transitional ruling or determination letter, paragraph (e)(13) (x) and (xii) of this section (relating to unrestricted gifts and excess holdings, respectively) shall be applied without regard to assets acquired prior to November 11, 1976. In addition, if within 1 year from acquiring any asset, the community trust removes any restriction inconsistent with paragraph (e)(13) of this section, such asset shall be treated as if it were not subject to such restriction as of the time it was acquired. Since under paragraph (e)(12)(ii)(D) of this section, a community trust does not have to meet the requirements of paragraph (e)(13) of this section for taxable years beginning prior to the date of its application for the transitional ruling or determination letter, then if the community trust makes such application in its taxable year beginning 1977 and it terminates such ruling or determination letter in such year as well, such a community trust does not have to meet such requirements for any taxable year.

(E) After the transitional ruling or determination letter of an organization has expired or been terminated under paragraph (e)(12)(iii) of this section, the organization must qualify as a ''publicly supported'' organization pursuant to the rules set forth in paragraph (e) (1) through (11) of this section. Thus, since the transitional ruling period of a community trust expires with its taxable year beginning in 1981, for its taxable year beginning in 1982 and thereafter, the community trust must meet the requirements of paragraph (e) (2) or (3) of this section based upon the 4-year computation period under paragraph (e)(4) of this section.

(iii) *Termination of transitional ruling.* (A) The transitional ruling or determination letter issued under this paragraph is subject to termination under paragraph (e)(12)(iii) (B) or (D) of this section without a request from the organization. In addition, such a ruling or determination letter is subject to termination under paragraph (e)(12)(iii)(E) of this section at the request of the organization. A transitional ruling or determination letter is subject to termination for any taxable year beginning after December 31, 1976, and before January 1, 1982, under paragraph (e)(12)(iii) (B), (D) or (E) of this section.

(B) The transitional ruling or determination letter issued under this paragraph shall be terminated for any taxable year (if such a year begins after its tenth taxable year) beginning in 1978, 1979, 1980 or 1981 for which a community trust receiving such a ruling or determination letter fails to meet the requirements of paragraph (e) (2) or (3) of this section for a 10-year computation period, except as provided in paragraph (e)(12)(iii)(C) of this section.

(C) In applying paragraph (e)(12)(iii)(B) of this section to a community trust described in paragraph (e)(12)(ii)(B)(*1*) of this section, a computation period consisting of the number of taxable years (but not more than 20 nor less than 10) preceding such taxable year that the organization has been in existence shall be substituted for the 10-year computation period until the first taxable year beginning in 1978, 1979, 1980 or 1981 that the community trust can meet the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period.

(D) The Commissioner may, at the discretion of the Commissioner, terminate the transitional ruling or determation letter of any community trust for any taxable year beginning prior to January 1, 1982, for which the organization fails to meet the requirements of paragraph (e) (11), (12) or (13) of this section as provided in paragraph (e)(12)(ii) of this section.

(E) A community trust may request an immediate termination of the community trust's transitional ruling or determination letter in order that, for the current taxable year, it may be determined if such community trust meets the requirements of paragraph (e) (2) or (3) of this section based upon a 4-year computation period under paragraph (e)(4) of this section. Such a request shall be granted and the transitional ruling or determination letter terminated only if the community trust meets such requirements, and in the case of an organization that has been in existence less than 11 taxable years at the time of such request, the organization also meets the requirements of paragraph (e) (2) or (3) of this section for the computation period consisting of the taxable years that the organization has been in existence.

(iv) *Initial determination of status.* (A) The initial determination of status of a community trust is the first determination (other than by issuance of an advance ruling or determination letter under paragraph (e)(5) or a transitional ruling or determination letter under paragraph (e)(12)(ii) of this section) that the community trust will be considered as ''normally'' meeting the requirements of paragraph (e) (2) or (3) of this section for a period beginning with its first taxable year.

(B)(*1*) In the case of a community trust described in paragraph (e)(12)(i)(B) of this section, the initial determination of status shall be made for the community trust's taxable year beginning in 1977 if such community trust has met the requirements of paragraph (e) (2) or (3) of this section for its taxable year beginning in 1977, based upon a 10-year computation period.

(*2*) In the case of any other community trust described in paragraph (e)(12)(i)(B) of this section (but not described in paragraph (e)(12)(iv) (B)(*1*) of this section), the initial determination of status shall be made for its first taxable year beginning after December 31, 1976 and before January 1, 1982, for which it meets the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period (if the community trust has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(C) In the case of a community trust described in paragraph (e)(12)(i)(A) of this section (relating to an organization in existence less than 9 taxable years) that reaches its 11th taxable year before its taxable year beginning in 1982, its initial determination of status a 10-year computation period (if it has received a transitional ruling or determination letter that has not been terminated before such taxable year).

(D) If a community trust has not received an initial determination of status shall be for its 11th taxable year based upon prior to the expiration or termination of its transitional ruling period, the initial determination of status shall be made:

(*1*) In the case of an expiration, for the taxable year beginning in 1982, or

(*2*) In the case of a termination, for the last taxable year of the terminated transitional period.

Based upon a 4-year computation period under paragraph (e)(4) of this section. In the case of an organization that has been in existence less than 11 taxable years at such time, the initial determination of status shall also be based upon a computation period consisting of the taxable years it has been in existence. For example, if the initial determination of status (for an organization that has been in existence for at least 11 taxable years) is made for its taxable year beginning in 1982, then, except as provided in paragraph (e)(4)(v) of this section (relating to exception for material changes of support), such determination shall be based upon a 4-year computation period ending with the taxable year beginning in 1980 or 1981 (treating the taxable year beginning in 1982, as the subsequent year or current year, respectively).

On the other hand, if, for example, the transitional ruling or determination letter is terminated in the taxable year beginning in 1980, then, except as provided in such paragraph (e)(4)(v), the initial determination of status shall be made for the taxable year beginning in 1980 based upon the 4-year computation period ending with the taxable year beginning in 1978 or 1979.

(v) *Special rules*—(A) Consequences of organization failing to meet requirements at end of transitional period. If upon the expiration (or termination) of the transitional period an organization with a transitional ruling or determination letter fails to meet the requirements of paragraph (e) (2) or (3) of this section based upon the 4-year computation period of paragraph (e)(4) of this section, it shall not be treated as an organization described in section 170(b)(1)(A)(vi) for its taxable year beginning in 1982 (or for the last taxable year of its terminated transitional period, as the case may be). If, by reason of failing to qualify as an organization described in section 170(b)(1)(A)(vi), such organization becomes a private foundation, then the organization will be a private foundation for its taxable year beginning in 1982 (or the last taxable year of its terminated transitional period, as the case may be) and all subsequent taxable years, unless and until it terminates its status under section 507. In addition, such an organization is a private foundation for all taxable years beginning prior to its taxable year beginning in 1982 (or for the last taxable year of the terminated transition period, as the case may be), except:

(*1*) That if the organization had received an initial determination of status that it met the requirements of paragraph (e) (2) or (3) of this section, then the organization will be treated as ''publicly supported'' for the taxable years to which the initial determination of status is effective, as well as for all taxable years beginning after the last of such years and before January 1, 1982, for which the organization consecutively meets the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period,

(*2*) That in the case of an organization that has reached its tenth taxable year of existence before January 1, 1970, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, then the organization will be treated as ''publicly supported'' for each taxable year beginning before January 1, 1977, that the organization, beginning with the taxable year beginning in 1970, consecutively met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period, or

(*3*) That in the case of an organization whose 11th taxable year of its existence began after December 31, 1970 and before January 1, 1977, if the organization has not received an initial determination of status prior to its taxable year beginning in 1982, but the organization for its 11th taxable year of existence met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period, then the organization will be treated as ''publicly supported'' for the first 12 taxable years of its existence. In addition, such an organization will be so treated for its 13th taxable year and each subsequent taxable year (if

such a year begins before January 1, 1977) that the organization, beginning with its 12th taxable year, consecutively met the requirements of paragraph (e) (2) or (3) of this section based upon a 10-year computation period.

(*4*) To the extent provided in paragraph (e)(4)(vii) of this section (relating to special rule for organization with existing rulings), § 1.508–1(b) (relating to notice that an organization is not a private foundation) or § 1.509(a)–7 (relating to reliance by grantors and contributors to section 509(a) (1), (2), and (3) organizations).

(B) *Computation period.* In applying the requirements of paragraph (e) (2) or (3) of this section to a 10-year or other computation period under paragraph (e) (12) or (13) of this section, such 10-year or other computation period shall be substituted for the 4-year computation period of paragraph (e)(4) of this section. Thus, for example, an organization will (except as provided in paragraph (e)(4)(v) of this section relating to exemption for material changes in sources of support) meet the ''publicly supported'' test of this paragraph for the taxable year beginning in 1977 based upon a 10-year computation period, if it met the requirements of paragraph (e) (2) or (3) of this section for a computation period consisting of either the taxable years beginning in the years 1966 through 1975 or the years 1967 through 1976, since under paragraph (e)(4) of this section, meeting the requirements for a computation period is effective for the current taxable year and the immediately succeeding taxable year. However, in substituting a 10-year or other computation period for the 4-year computation period of paragraph (e)(4) of this section, the rules of such paragraph (e) (4) and (6) apply, including the 2-percent limitation under paragraph (e)(6)(i) of this section and the exclusion for unusual grants under paragraph (e)(6)(ii) of this section. In applying such provisions, the fact that the computation period is other than a 4-year computation period shall be taken into account, so that, for example, the 2-percent limitation shall be applied, in the case of a 10-year computation period, with reference to 2 percent of the organization's total support for the 10-year computation period rather than a 4-year computation period.

In addition, in substituting a 10-year or other computation period for purposes of paragraph (e)(3) of this section, all of the facts and circumstances referred to in such paragraph (e)(3) shall be considered with respect to such period, viewing such period as a whole. See, also, paragraph (e)(10) of this section with respect to the organization being organized and operated to attract public support.

(C) *First taxable year of less than 8 months.* In the case of an organization whose first taxable year consisted of less than 8 months, in order to coordinate the rules of paragraph (e)(12) of this section with the rules of paragraph (e)(5) of this section, in applying the rules of paragraph (e)(12) of this section, such an organization shall be treated as organized at the beginning of its succeeding taxable year, so that such succeeding taxable year shall be treated as its first taxable year of existence. However, the support received for the period preceding such succeeding taxable year shall be taken into account with the support received in such succeeding taxable year.

(13) *Community trusts; requirements for 5-year transitional ruling period*—(i) *In general.* In order for a community trust to be eligible for a transitional ruling or determination letter for the transitional ruling period under paragraph (e)(12) of this section, it must establish that it is organized, and will be operated, in such manner that it can reasonably be expected to meet the requirements of paragraph (e)(13) of this section, and can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section, for each taxable year during and immediately following the transitional ruling period, as provided in paragraph (e)(12)(ii) of this section. In determining whether an organization can reasonably be expected to meet the requirements of paragraph (e) (2) or (3) of this section for each such taxable year, the basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities,

and governmental units which is necessary to meet such tests. The information to be considered for this purpose shall consist of all pertinent facts and circumstances relating to the requirements set forth in paragraph (e)(3) of this section. For purposes of meeting the requirements of paragraph (e)(13) of this section, a community trust may, prior to its application for a transitional ruling or determination letter under paragraph (e)(12)(i)(C) of this section, adopt a resolution stating that, as a matter of policy, it will attempt to meet the conditions set forth in paragraph (e)(13) of this section during the transitional ruling period. A community trust will not be treated as failing to satisfy the requirements of paragraph (e)(13) of this section merely because the governing body, or any of its trustees, agents, or custodians, fails to meet one or more of the requirements contained in paragraph (e)(13) (ii) through (xiii) of this section by reason of isolated and nonrepetitive acts. However, any continuing pattern on the part of the governing body, or its trustees, agents or custodians, indicating a continued and repetitive failure to comply with a policy of meeting such requirements will result in termination of the transitional ruling or determination letter under paragraph (e)(12)(iii)(D) of this section.

(ii) *Area.* The community trust is organized and operated exclusively to carry out charitable purposes (within the meeting of section 170(c) (1) or (2)(B)) primarily within a broad geographical area which it serves, such as a municipality, county, metropolitan area, State or region.

(iii) *General composition of governing body.* The governing body must represent the board interests of the public rather than the personal or private interests of a limited number of donors. An organization will be treated as meeting this requirement if it has a governing body comprised of public officials acting in their capacities as such; individuals selected by public officials acting in their capacities as such; persons having special knowledge or expertise in a particular field or discipline in which the community trust operates; 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 area served.

(iv) *Rules for governing body.* With respect to terms of office beginning after the date of the application of the community trust for a transitional ruling or determination letter:

(A) Its governing body is comprised of members who may serve a period of not more than ten consecutive years;

(B) Upon completion of a period of service (beginning before or after such date) no person may serve within a period consisting of the lesser of 5 years or the number of consecutive years the member has immediately completed serving;

(C) Persons who would be described in section 4946(a)(1) (A) or (C) through (G) if the community trust were a private foundation do not constitute more than one-third of its governing body; and

(D) Representatives of banks or trust companies which serve as trustees, investment managers, custodians, or agents, plus persons described in paragraph (e)(13)(iv)(C) of this section, do not constitute a majority of the governing body.

No term of office beginning on or before the date of such application may continue for more than 10 years from such date.

(v) *Fiduciary responsibility.* Fiduciary responsibility with respect to the funds of the community trust is imposed, either by the master trust or agency agreement or by State law, on either its governing body or its trustee banks or trust companies or both.

(vi) *Ultimate control of assets.* Neither its governing body, nor any of its trustees, investment managers, custodians or agents may be subjected by any donor to the community trust to any material condition or restriction within the meaning of § 1.507–2(a)(8) which would prevent it from exercising ultimate control over its assets.

(vii) *Administration.* Administration and investment of all gifts and bequests are accomplished through:

(A) A governing body which directly holds, administers or invests such gifts and bequests exclusively for charitable purposes;

(B) Banks or trust companies (acting or appointed as trustees), investment managers, custodians or agents of the community trust or one or more components thereof; or

(C) A combination of such persons.

(viii) *Annual distributions.* It makes annual distributions for purposes described in section 170(c) (1) or (2)(B), including administrative expenses and amounts paid to acquire an asset used (or held for use) directly in carrying out one or more of such purposes, in an amount not less than its adjusted net income (as defined in section 4942(f)). For purposes of paragraph (e)(13)(viii) of this section, the term ''distributions'' shall include amounts set aside for a specific project, but only if prior to making the set-aside the organization has, pursuant to a request for a ruling, established to the satisfaction of the Commissioner that:

(A) The amount will be paid for the specific project within 5 years; and

(B) The project is one which can be better accomplished by such set-aside than by immediate distribution of funds.

All annual distributions required to be made pursuant to paragraph (e)(13)(viii) of this section, except for set-asides, must be made no later than the close of the organization's first taxable year after the taxable year for which the adjusted net income is computed. Thus, in the case of a calendar year community trust which has received a transitional ruling or determination letter upon an application made in 1977, it must make distributions under paragraph (e)(13)(vii) of this section for 1978, 1979, 1980 and 1981 based upon its adjusted net income for 1977, 1978, 1979 and 1980, respectively, unless its transitional ruling or determination letter is terminated. If such a community trust's transitional ruling or determination letter is terminated in 1979, it must make distributions under paragraph (e)(13)(viii) of this section only for 1978 based upon its adjusted net income for 1977. On the other hand, if such ruling or letter is terminated in 1977 or 1978, no distribution under paragraph (e)(13)(viii) of this section need be made.

(ix) *Net income.* The community trust's funds must, on an aggregate basis, be invested to produce an annual adjusted net income (as defined in section 4942(f)) of not less than two-thirds of what would be its minimum investment return (within the meaning of section 4942(e)) if such organization were a private foundation.

(x) *Unrestricted gifts.* At least one-half of the total income which the community trust derives from the investment of gifts and bequests received must be unrestricted (within the meaning of this (x)) with respect to its availability for distribution by the governing body. For purposes of this (x), any income which 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 which 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.

(xi) *Self-dealing.* The community trust may not engage in any act with any person (other than a foundation manager acting only in such capacity) which would constitute self-dealing within the meaning of section 4941 if such community trust were a private foundation.

(xii) *Excess holdings.* The community trust must dispose of any holdings which would constitute excess business holdings (within the meaning of section 4943—applied on a component-by-component basis as if each component were a private foundation, except that components will be combined for purposes of this paragraph if such components would have been described in section 4946(a)(1)(H)(ii)).

(xiii) *Expenditure responsibility.* The community trust must exercise expenditure responsibility (within the meaning of section 4945(h)) through either its governing body, trustees, investment managers, custodians, or agents with respect to any grant which would otherwise constitute a taxable

expenditure under section 4945(d)(4) if the community trust were a private foundation, except that it need not make the reports required of private foundations by section 4945(h)(3).

(14) *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 which is alleged to be a component part of a community trust, but which fails to meet the requirements of paragraph (e)(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 or section 4947(a) (1) or (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), (2), (3), or (4). Any transfer made in connection with the creation of such separate trust or not-for-profit organization, or to such entity, will not be treated as being made ''to'' the community trust or one of its components for purposes of sections 170(b)(1)(A) and 507(b)(1)(A) even though a deduction with respect to such transfer is allowable under §1,170–1(e), §20.2055–2(b), or §25.2522(a)–2(b), unless such treatment is permitted under §1.170A–9(e)(4)(v)(*b*) or §1.508–1(b)(4). In the case of a fund which is ultimately treated as not being a component part of a community trust pursuant to paragraph (e)(14) of this section, 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 (e)(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 regulations thereunder for the treatment of such split-interest trusts. The provisions of this (ii) only provide rules 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. Thus, 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)(E)(iii) will not ordinarily satisfy the requirements of paragraph (e)(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 (e)(14)(i) of this section. However, see section 170(b)(1)(E)(iii) and the regulations thereunder with respect to the

treatment of contributions to such organizations.

(f) *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.

(g) *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).

(h) *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.

(i) *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.

[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]

§ 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

1973

Contribution year	Total excess	Less: Amount treated as paid in year prior to 1973	Available charitable contributions carryovers
			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		Less: Amount treated as paid in years prior to 1971	Available charitable contributions carryovers	
	50%	30%		50%	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		Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers	
	50%	30%		50%	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		Less: Amount treated as paid in years prior to 1972	Available charitable contributions carryovers	
	50%	30%		50%	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		Less: Amount treated as paid in years prior to 1973	Available charitable contributions carryovers	
	50%	30%		50%	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		Less: Amount treated as paid in years prior to 1974	Available charitable contributions carryovers	
	50%	30%		50%	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		Less: Amount treated as paid in years prior to 1974	Available charitable contributions carryovers	
	50%	30%		50%	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) [Reserved]. For further guidance *see* § 1.170A–11T(b)(2).

(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]

§ 1.170A–11T Limitation on, and carryover of, contributions by corporations (temporary).

(a) [Reserved]. For further guidance, *see* § 1.170A–11(a).

(b) Election by corporations on an accrual method—(1) [Reserved]. For further guidance, *see* § 1.170A–11(b)(1).

(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) through (d) [Reserved]. For further guidance, *see* § 1.170A–11(c) through (d).

[T.D. 9100, 68 FR 70704, Dec. 19, 2003]

§ 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 contingencies prescribed in § 20.2031–7 of this chapter (or for periods before May 1, 1999, § 20.2031–7A) 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 after April 30, 1999, special factors for determining the present value of a remainder interest following one life and an example describing the computation is contained in Internal Revenue Service Publication 1459, ''Actuarial Values, Book Gimel,'' (7–1999). A copy of this publication is available for purchase from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. For transfers for which the valuation date is after April 30, 1989, and before May 1, 1999, special factors for determining the present value of a remainder interest following one life and an example describing the computation is contained in Internal Revenue Service Publication 1459, ''Actuarial Values, Gamma Volume,'' (8–89). This publication is no longer available for purchase from the Superintendent of Documents. However, it may be obtained by requesting a copy from: CC:DOM:CORP:R (IRS Publication 1459), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. 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 following formula:

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} v^{(t+1)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

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 divided by the sum of 1 plus the applicable interest rate under section 7520 of the Internal Revenue Code,

x = the age of the life tenant, and

lx = number of persons living at age x as set forth in Table 90CM of § 20.2031–7 (or, for periods before May 1, 1999, the tables set forth under § 20.2031–7A) of this chapter.

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

Example. 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 45 years, at the end of which the value of the house is expected to be $20,000. The portion of the property considered to be depreciable is $80,000 (the value of the house ($100,000) less its expected value at the end of 45 years ($20,000)). The portion of the property considered to be nondepreciable is $50,000 (the value of the land at the time of the gift ($30,000) plus the expected value of the house at the end of 45 years ($20,000)). At the time of the gift, the interest rate prescribed under section 7520 is 8.4 percent. Based on an interest rate of 8.4 percent, the remainder factor for $1.00 prescribed in § 20.2031–7(d) of this chapter for a person age 62 is 0.27925. The value of the nondepreciable remainder interest is $13,962.50 (0.27925 times $50,000). The value of the depreciable remainder interest is $16,148.80 (0.20186, computed under the formula described in paragraph (b)(2) of this section, times $80,000). Therefore, the value of the remainder interest is $30,111.30.

(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 following formula:

$$\left(1+\frac{i}{2}\right)\sum_{t=0}^{n-1} V^{(t+1)}\left[\left(1-\frac{l_{x+t+1}}{l_x}\right)\left(1-\frac{l_{y+t+1}}{l_y}\right)-\left(1-\frac{l_{x+t}}{l_x}\right)\left(1-\frac{l_{y+t}}{l_y}\right)\right]\left(1-\frac{1}{2n}-\frac{t}{n}\right)$$

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 divided by the sum of 1 plus the applicable interest rate under section 7520 of the Internal Revenue Code,

x and y=the ages of the life tenants, and

lx and ly=the number of persons living at ages x and y as set forth in Table 90 CM in §20.2031–7 (or, for prior periods, in §20.2031–7A) of this chapter.

(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.

[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]

§ 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 inter-dealer 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)(4) 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 and 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]

§ 1.170A–14 Qualified conservation contributions.

(a) *Qualified conservation contributions.* A deduction under section 170 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. 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 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.

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).

Example 2. In 1984 B, who is 62, donates a remainder interest in Greenacre to a qualifying organization for conservation purposes. 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 term of years, and remainder or reversionary interests transferred before May 1, 1999.) 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×.27998).

Example 3. Assume the same facts as in *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 pursunt 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).

Example 4. Assume the same facts as in *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).

Example 5. Assume the same facts as in *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).

Example 6. Assume the same facts as in *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).

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).

Example 8. Assume the same facts as in *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).

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).

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.

Example 11. Assume the same facts as in *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.

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 after 1984), and section 6659 (relating to additions to tax in the case of valuation overstatements).

(j) *Effective date.* Except as otherwise provided in § 1.170A–14(g)(4)(ii), this section applies only to contributions made on or after December 18, 1980.

[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]

§ 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.

(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 11, 1998, A purchases for $1,100 B corporation's bond maturing on January 1, 2001, 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 January 1, 1998, B corporation's nonconvertible, publicly-traded, three-year debt with a similar credit rating 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 January 1, 1998, 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.

[T.D. 8746, 62 FR 68177, Dec. 31, 1997]

§ 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.

(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]

§ 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). 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

Accrual period ending	Adjusted acquisition price at beginning of accrual period	Premium allocable to accrual period
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]

§ 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) 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.

(2) 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.

(3) 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.

(4) For purposes of paragraph (a)(3)(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.

(5) 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.

(6) 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)(6) does not apply to the reasonableness of the type or nature of the activities themselves.

(7) This paragraph (a) applies to taxable years beginning after October 3, 1994.

(8) 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.

(9) The application of subparagraph (2) of this paragraph may be illustrated by the following examples:

Example 1. 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. X Corporation, a manufacturer of explosives, contracts with the Y 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, Y 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 Y will transfer this tract, including any improvements thereon, to X. Section 174 does not apply to the amount paid to Y representing the costs of the tract of land and improvements.

(b) *Certain expenditures with respect to land and other property.* (1) 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, allowances 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) 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) 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) The deductions referred to in subparagraphs (2) and (3) of this paragraph 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. For the purpose of the preceding sentence, amounts expended for research or experimentation do not include the costs of the component materials of the depreciable property, the costs of labor or other elements involved in its construction and installation, or costs attributable to the acquisition or improvement of the property. For example, a taxpayer undertakes to develop a new machine for use in his business. He expends $30,000 on the project of which $10,000 represents the actual costs of material, labor, etc., to construct the machine, and $20,000 represents research costs which are not attributable to the machine itself. Under section 174(a) the taxpayer would be permitted to deduct the $20,000 as expenses not chargeable to capital account, but the $10,000 must be charged to the asset account (the machine).

(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.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8562, 59 FR 50160, Oct. 3, 1994]

§ 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]

§ 1.177–1 Election to amortize trademark and trade name expenditures.

(a) *In general.* (1) Section 177 provides that a taxpayer may elect to treat any trademark or trade name expenditure (defined in section 177(b) and paragraph (b) of this section) paid or incurred during a taxable year beginning after December 31, 1955, as a deferred expense. Any expenditure so treated shall be allowed as a deduction ratably over the number of continuous months (not less than 60) selected by the taxpayer, beginning with the first month of the taxable year in which the expenditure is paid or incurred. The term *paid or incurred,* as used in section 177 and this section, is to be construed according to the method of accounting used by the taxpayer in computing taxable income. See section 7701(a)(25). An election under section 177 is irrevocable insofar as it applies to a particular trademark or trade name expenditure, but separate elections may be made with respect to other trademark or trade name expenditures. See subparagraph (3) of this paragraph. See also paragraph (c) of this section for time and manner of making election.

(2) The number of continuous months selected by the taxpayer may be equal to or greater, but not less than 60, but in any event the deduction must begin with the first month of the taxable year in which the expenditure is paid or incurred. The number of months selected by the taxpayer at the time he makes the election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(3) Section 177 permits an election by the taxpayer for each separate trademark or trade name expenditure. Thus, a taxpayer who has several trademark or trade name expenditures in a taxable year may elect under section 177 with respect to some of such expenditures and not elect with respect to the other expenditures. Also, a taxpayer may choose different amortization periods for different trademark or trade name expenditures with respect to which he has made the election under section 177.

(4) All trademark and trade name expenditures are properly chargeable to capital account for purposes of section 1016(a)(1), relating to adjustments to basis of property, whether or not they are to be amortized under section 177. However, the trademark and trade name expenditures with respect to which the taxpayer has made an election under section 177 must be kept in

a separate account in the taxpayer's books and records. See paragraph (c) of this section. See also section 1016(a)(16) and paragraph (m) of § 1.1016–5 for adjustments to basis of property for amounts allowed as deductions under section 177 and this section.

(b) *Trademark and trade name expenditures defined.* (1) The term *trademark and trade name expenditures,* as used in section 177 and this section, means any expenditure which:

(i) Is directly connected with the acquisition, protection, expansion, registration (Federal, State, or foreign), or defense of a trademark or trade name;

(ii) Is chargeable to capital account; and

(iii) Is not part of the consideration or purchase price paid for a trademark, trade name, or a business (including goodwill) already in existence.

An expenditure which fails to meet one or more of these tests is not a trademark or trade name expenditure for purposes of section 177 and this section.

Amounts paid in connection with the acquisition of an existing trademark or trade name may not be amortized under section 177 even though such amounts may be paid to protect or expand a previously owned trademark or trade name through purchase of a competitive trademark. Similarly, the provisions of section 177 and this section are not applicable to expenditures paid or incurred for an agreement to discontinue the use of a trademark or trade name (if the effect of the agreement is the purchase of a trademark or trade name) nor to expenditures paid or incurred in acquiring franchises or rights to the use of a trademark or trade name. Generally, section 177 will apply to expenditures such as legal fees and other costs in connection with the acquisition of a certificate of registration of a trademark from the United States or other government, artists' fees and similar expenses connected with the design of a distinctive mark for a product or service, litigation expenses connected with infringement proceedings, and costs in connection with the preparation and filing of an application for renewal of registration and continued use of a trademark.

(2) Expenditures for a trademark or trade name which has a determinable useful life and which would otherwise be depreciable under section 167 must be deferred and amortized under section 177 if an election under section 177 is made with respect to such expenditures.

(3) The following examples illustrate the application of section 177:

Example 1. X Corporation engages an artist to design a distinctive trademark for its product. At the same time it retains an attorney to prepare the papers necessary for registration of this trademark with the Federal Government. The fees of both the artist and the attorney may be amortized under section 177 over a period of not less than 60 continuous months.

Example 2. Y Corporation wishes to expand the market served by its product. It acquires a competing firm in a neighboring State. The contract of sale provides for a purchase price of $250,000 of which $225,000 shall constitute payment for physical assets and $25,000 for the trademark and goodwill. No part of the purchase price may be amortized under section 177.

Example 3. M Corporation brings suit against N Corporation for infringement of M's trademark. The costs of this litigation may be amortized under section 177.

(c) *Time and manner of making election.* (1) A taxpayer who elects to defer and amortize any trademark or trade name expenditure paid or incurred during a taxable year beginning after December 31, 1955, shall, within the time prescribed by law (including extensions thereof) for filing his income tax return for that year, attach to his income tax return a statement signifying his election under section 177 and setting forth the following:

(i) Name and address of the taxpayer, and the taxable year involved;

(ii) An identification of the character and amount of each expenditure to which the election applies and the number of continuous months (not less than 60) during which the expenditures are to be ratably deducted; and

(iii) A declaration by the taxpayer that he will make an accounting segregation on his books and records of the trademark and trade name expenditures for which the election has been made, sufficient to permit an identification of the character and amount of

each such expenditure and the amortization period selected for each expenditure.

(2) The provisions of subparagraph (1) of this paragraph shall apply to income tax returns and statements required to be filed after May 4, 1960. Elections properly made in accordance with the provisions of Treasury Decision 6209, approved October 26, 1956 (21 FR 8319, C.B. 1956–2, 1370), continue in effect.

§ 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 (12 1/2 years) and the 10-year renewal period, or 22 1/2 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]

§ 1.178–2 Related lessee and lessor.

(a) For purposes of section 178 and § 1.178–1, a lessor and lessee shall be considered to be related persons if:

(1) The lessor and lessee are members of an affiliated group, as defined in section 1504 and the regulations thereunder; or

(2) The relationship between the lessor and lessee is one described in section 267(b), except that the phrase ''80 percent or more'' shall be substituted for the phrase ''more than 50 percent'' wherever such phrase appears in section 267(b).

(b) In the application of section 267(b) for purposes of section 178, the rules provided in section 267(c) shall apply,

except that the family of an individual shall include only his spouse, ancestors, and lineal descendants. Thus, if the lessee is the brother or sister of the lessor, the lessee and lessor will not be considered to be related persons for purposes of section 178 and § 1.178–1. If the lessor leases property to a corporation of which he owns 80 percent or more in value of the outstanding stock, the lessor and lessee shall be considered to be related persons. On the other hand, if the lessor leases property to a corporation of which he owns less than 80 percent in value of the outstanding stock and his brother owns the remaining stock, the lessor and lessee will not be considered to be related persons.

(c) If a relationship described in section 267(b) exists independently of family status, the brother-sister exception does not apply. For example, if the lessor leases property to the fiduciary of a trust of which he is the grantor, the lessor and lessee will be considered to be related persons for purposes of section 178. This result obtains whether or not the fiduciary is the brother or sister of the lessor since the disqualifying relationship exists because of the grantor-fiduciary status and not because of family status.

[T.D. 6520, 25 FR 13691, Dec. 24, 1960]

§ 1.178–3 Reasonable certainty test.

(a) In any case in which neither section 178 (a) nor (b) applies, the determination as to the amount of the deduction allowable to a lessee for any taxable year for depreciation or amortization in respect of any building erected, or other improvements made, on leased property, or in respect of any cost of acquiring a lease, shall be made with reference to the original term of the lease (excluding any period for which the lease may subsequently be renewed, extended, or continued pursuant to an option exercisable by the lessee) unless the lease has been renewed, extended, or continued, or the facts show with reasonable certainty that the lease will be renewed, extended, or continued. In a case in which the facts show with reasonable certainty that the lease will be renewed, extended, or continued, the term of the lease shall, beginning with the taxable year in which such reasonable certainty is shown, be treated as including the period or periods for which it is reasonably certain that the lease will be renewed, extended, or continued. If the lessee has given notice to the lessor of his intention to renew, extend, or continue a lease, the lease shall be considered as renewed, extended, or continued for the periods specified in the notice. See paragraph (c) of § 1.178–1.

(b) The reasonable certainty test is applicable to each option to which the lease is subject. Thus, in a case of two successive options, the facts in a particular taxable year may show with reasonable certainty that the lease will be renewed pursuant to an exercise of only the first option; and, beginning with such year, the term of the lease will be treated as including the first option, but not the second. If in a subsequent taxable year the facts show with reasonable certainty that the second option will also be exercised, the term of the lease shall, beginning with such subsequent taxable year, be treated as including both options. Although the related lessee and lessor rule of section 178(b) and paragraph (d) of § 1.178–1 does not apply in determining the period over which the cost of acquiring a lease may be amortized, the relationship between the lessee and lessor will be a significant factor in determining whether the ''reasonable certainty'' rule of section 178(c) and this section applies.

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

Example 1. Corporation A leases land from lessor B for a period of 30 years beginning with January 1, 1958. Corporation A and lessor B are not related persons. The lease provides that Corporation A will have two renewal options of 5 years each at the same annual rental as specified in the lease for the initial 30 years. Corporation A constructs a factory building on the leased land at a cost of $100,000. Corporation A was not, on July 28, 1958, under a binding legal obligation to erect the building. The construction was commenced on August 1, 1958, and was completed and placed in service on December 31, 1958. On January 1, 1959, Corporation A has 29 years remaining in the initial term of the lease. The estimated useful life of the building on January 1, 1959, is 40 years. The location of the leased property is particularly suitable for Corporation A's business and the annual rental of the property is lower than A

would have to pay for other suitable property. No factors are present which establish that these conditions will not continue to exist beyond the initial term of the lease. Since the period remaining in the initial term of the lease on January 1, 1959 (29 years) is not less than 60 percent of the estimated useful life of the building (60 percent of 40 years, or 24 years), the provisions of section 178(a) and paragraph (b)(1) of § 1.178–1 do not apply, and since Corporation A and lessor B are not related, section 178(b) and paragraph (d) of § 1.178–1 do not apply. However, since the facts show with reasonable certainty that Corporation A will renew the lease for the period of the two options (10 years), the cost of the building shall be amortized over the term of the lease, including the two renewal options, or 39 years.

Example 2. Assume the same facts as in *Example 1,* except that a term of 30 years is the longest period that lessor B is willing to lease the unimproved property; that there was no agreement that Corporation A will have any renewal options; and that any other location would be as suitable for Corporation A's business as the leased property. Since the facts do not show with reasonable certainty that the initial term of the lease will be renewed, extended, or continued, Corporation A shall amortize the cost of the building over the remaining term of the lease, or 29 years.

[T.D. 6520, 25 FR 13691, Dec. 24, 1960]

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(h) Special rules for partners and S corporation shareholders.
(1) In general.
(2) Dispositions and other transfers of a partner's interest in a partnership or a shareholder's interest in an S corporation.
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§ 1.179–4 Definitions

(a) Section 179 property [Reserved].
(b) Section 38 property.
(c) Purchase.
(d) Cost.
(e) Placed in service.
(f) Controlled group of corporations and component member of controlled group.

§ 1.179–4T Definitions.

(a) Section 179 property.
(b) through (f) [Reserved]

§ 1.179–5 Time and Manner of Making Election

(a) Election.
(b) Revocation.
(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

§ 1.179–5T Time and manner of making election.

(a) and (b) [Reserved]
(c) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

§ 1.179–6 Effective Date

§ 1.179–6T Effective dates.

(a) In general.
(b) Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006.

[T.D. 8455, 57 FR 61316, Dec. 24, 1992, as amended by T.D. 9146, 69 FR 46983, Aug. 4, 2004]

§ 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)

(1) [Reserved] For further guidance, *see* § 1.179–2T(b)(1).

(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) [Reserved] For further guidance, see § 1.179–2T(b)(2)(ii).

(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.

[T.D. 8455, 57 FR 61318, Dec. 24, 1992, as amended by T.D. 9146, 69 FR 46983, Aug. 4, 2004]

§ 1.179–2T Limitations on amount subject to section 179 election (temporary).

(a) [Reserved] For further guidance, *see* § 1.179–2(a).

(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 2006 under section 179(b)(1), indexed annually for inflation under section179(b)(5) for taxable years beginning after 2003 and before 2006), 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.

(b)(2) and (b)(2)(i) [Reserved] For further guidance, *see* § 1.179–2(b)(2) and (b)(2)(i).

(ii) $200,000 ($400,000 in the case of taxable years beginning after 2002 and before 2006 under section 179(b)(2), indexed annually for inflation under section 179(b)(5) for taxable years beginning after 2003 and before 2006).

(b)(3) through (d) [Reserved] For further guidance, *see* § 1.179–2(b)(3) through (d).

[T.D. 9146, 69 FR 46983, Aug. 4, 2004]

§ 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) [Reserved] For further guidance, *see* § 1.179–4T(a).

(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, or is determined under section 1014(a), relating to property acquired from a decedent. 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) 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]

§ 1.179–4T Definitions (temporary).

The following definitions apply for purposes of section 179, §§ 1.179–1 through 1.179–6, and § 1.179–2T, 5T, and 6T:

(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 2006, 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 2006 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 thereunder.

(b) through (f) [Reserved] For further guidance, *see* § 1.179–4(b) through (f).

[T.D. 9146, 69 FR 46984, Aug. 4, 2004]

§ 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 2006*. [Reserved] For further guidance, see § 1.179–5T(c).

[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]

§ 1.179–5T Time and manner of making election (temporary).

(a)and (b) [Reserved] For further guidance, see § 1.179–5(a) and (b).

(c) *Section 179 property placed in service by the taxpayer in a taxable year beginning after 2002 and before 2006*—(1) *In general.* For any taxable year beginning after 2002 and before 2006, 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 2006, 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 election.* 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 2006 (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 2006 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 2006 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 nonelected 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.

[T.D. 9146, 69 FR 46984, Aug. 4, 2004]

§ 1.179–6 Effective date.

The provisions of §§ 1.179–1 through 1.179–5 are effective for property placed in service 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 after December 31, 1986, in taxable years ending on or before January 25, 1993. Otherwise, for property placed in service 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, the Technical and Miscellaneous Revenue Act of 1988, and the Revenue Reconciliation Act of 1990. 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.

[T.D. 8455, 57 FR 61323, Dec. 24, 1992]

§ 1.179–6T Effective dates.

(a) *In general.* Except as provided in paragraph (b) 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 2006.* The provisions of § 1.179–2T, 1.179–4T, and 1.179–5T, reflecting changes made to section 179 by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (117 Stat. 752), apply for property placed in service in taxable years beginning after 2002 and before 2006.

[T.D. 9146, 69 FR 46985, Aug. 4, 2004]

§ 1.179A–1 Recapture of deduction for qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property.

(a) *In general.* If a recapture event occurs with respect to a taxpayer's qualified clean-fuel vehicle property or qualified clean-fuel vehicle refueling property, the taxpayer must include the recapture amount in taxable income for the taxable year in which the recapture event occurs.

(b) *Recapture event*—(1) *Qualified clean-fuel vehicle property*—(i) *In general.* A recapture event occurs if, within 3 full years from the date a vehicle of which qualified clean-fuel vehicle property is a part is placed in service, the property ceases to be qualified clean-fuel vehicle property. Property ceases to be qualified clean-fuel vehicle property if—

(A) The vehicle is modified by the taxpayer so that it may no longer be propelled by a clean-burning fuel;

(B) The vehicle is used by the taxpayer in a manner described in section 50(b);

(C) The vehicle otherwise ceases to qualify as property defined in section 179A(c); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(1)(i) (A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(1)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle property is not a recapture event.

(2) *Qualified clean-fuel vehicle refueling property*—(i) *In general.* A recapture event occurs if, at any time before the end of its recovery period, the property ceases to be qualified clean-fuel vehicle refueling property. Property ceases to be qualified clean-fuel vehicle refueling property if—

(A) The property no longer qualifies as property described in section 179A(d);

(B) The property is no longer used predominantly in a trade or business (property will be treated as no longer used predominantly in a trade or business if 50 percent or more of the use of the property in a taxable year is for use other than in a trade or business);

(C) The property is used by the taxpayer in a manner described in section 50(b); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the property and knows or has reason to know that the property will be used in a manner described in paragraph (b)(2)(i) (A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle refueling property is not a recapture event.

(c) *Recapture date*—(1) *Qualified clean-fuel vehicle property.* The recapture date is the actual date of the recapture event unless an event described in paragraph (b)(1)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture date is the actual date of the recapture event unless the recapture occurs as a result of an event described in paragraph (b)(2)(i) (B) or (C) of this section, in which case the recapture date is the first day of the recapture year.

(d) *Recapture amount*—(1) *Qualified clean-fuel vehicle property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the recapture percentage. The recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) 66⅔, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) 33⅓, if the recapture date is within the third full year after the date the vehicle is placed in service.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the following fraction. The numerator of the fraction equals the total recovery period for the property minus the number of recovery years prior to, but not including, the recapture year. The denominator of the fraction equals the total recovery period.

(e) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the vehicle of which qualified clean-fuel vehicle property is a part or the basis of qualified clean-fuel vehicle refueling property is increased by the recapture amount. For a vehicle or refueling property that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over its remaining recovery period beginning as of the first day of the taxable year in which the recapture event occurs.

(f) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the deduction allowable under section 179A(a) with respect to any property that is (or has been) of a character subject to an allowance for depreciation is treated as

a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of depreciable qualified clean-fuel vehicle refueling property or a depreciable vehicle of which qualified clean-fuel vehicle property is a part, section 1245 will apply to any gain recognized to the extent the basis of the depreciable property or vehicle was reduced under section 179A(e)(6) net of any basis increase described in paragraph (e) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a clean-fuel vehicle, a portion of which is qualified clean-fuel vehicle property, costing $25,000. The qualified clean-fuel vehicle property costs $11,000. On A's 1995 federal income tax return, A claims a section 179A deduction of $2,000. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a gasoline-propelled vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to a gasoline-propelled vehicle.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a clean-fuel vehicle costing $20,000, a portion of which is qualified clean-fuel vehicle property. The qualified clean-fuel vehicle property costs $10,000. On B's 1994 federal income tax return, B claims a deduction of $2,000, which reduces B's gross income by $2,000. The basis of the vehicle is reduced to $18,000 ($20,000 − $2,000). On January 31, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture $1,333 ($2,000 × 66⅔ percent). This recapture amount increases B's gross income by $1,333 on B's 1996 federal income tax return and is added to the basis of the motor vehicle as of January 1, 1996, the beginning of the taxable year of recapture.

Example 3. X, a calendar-year taxpayer, purchases and places in service for its business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing $400,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of $100,000, which reduces X's gross income by $100,000. The basis of the property is reduced to $300,000 ($400,000 − $100,000) prior to any adjustments for depreciation. In 1996, more than 50 percent of the use of the property is other than in X's trade or business.

Because the property is no longer used predominantly in X's business, X must recapture three-fifths of the section 179A deduction or $60,000 ($100,000×(5–2)/5 = $60,000) and include that amount in gross income on its 1996 federal income tax return. The recapture amount of $60,000 is added to the basis of the property as of January 1, 1996, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing $350,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of $100,000, which reduces X's gross income by $100,000. The basis of the property is reduced to $250,000 ($350,000 − $100,000) prior to any adjustments for depreciation. In 1995, X converts the property to store and dispense gasoline. Because the property is no longer used as qualified clean-fuel vehicle refueling property in 1995, X must recapture four-fifths of the section 179A deduction or $80,000 ($100,000×(5–1)/5 = $80,000) and include that amount in gross income on its 1995 federal income tax return. The recapture amount of $80,000 is added to the basis of the property as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 5. The facts are the same as in *Example 4.* In 1996, X sells the refueling property for $351,000, recognizing a gain from this sale. Under paragraph (f) of this section, section 1245 will apply to any gain recognized on the sale of depreciable property to the extent the basis of the property was reduced by the section 179A deduction net of any basis increase from recapture of the section 179A deduction. Accordingly, the gain from the sale of the property is subject to section 1245 to the extent of the depreciation allowance for the property plus the deduction allowed under section 179A ($100,000), less the previous recapture amount ($80,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(h) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any deduction allowable under section 179A(a) consistent with section 179A and its legislative history.

For this purpose, the recapture date is defined in paragraph (c) of this section.

[T.D.8606, 60 FR 39651, Aug. 3, 1995]

§ 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]

§ 1.182–1 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) × 1/2]	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, 2/3 (2 months of rental use over 3 months of total use) of each of these expenses are allocated to the rental use, and 1/3 (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 (10,000/40,000×3,000), $375 to the return of capital (5,000/40,000×3,000), and $1,875 to the punitive damages (25,000/40,000× 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 secton 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)). A taxpayer who elects to amortize start-up expenditures must, at the time of the election, select an amortization period of not less than 60 months, beginning with the month in which the active trade or business begins. The election applies to all of the taxpayer's start-up expenditures with respect to the trade or business. The election to amortize start-up expenditures is irrevocable, and the amortization period selected by the taxpayer in making the election may not subsequently be changed.

(b) *Time and manner of making election.* The election to amortize start-up expenditures under section 195 shall be made by attaching a statement containing the information described in paragraph (c) of this section to the taxpayer's return. The statement must be filed no later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the active trade or business begins. The statement may be filed with a return for any taxable year prior to the year in which the taxpayer's active trade or business begins, but no later than the date prescribed in the preceding sentence. Accordingly, an election under section 195 filed for any taxable year prior to the year in which the taxpayer's active trade or business begins (and pursuant to which the taxpayer commenced amortizing start-up expenditures in that prior year) will become effective in the month of the year in which the taxpayer's active trade or business begins.

(c) *Information required.* The statement shall set forth a description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the taxable year in which the statement is filed and for all future taxable years to which it relates. The statement also shall include the number of months (not less than 60) over which the expenditures are to be amortized, and to the extent known at the time the statement is filed, a description of each start-up expenditure incurred (whether or not paid) and the month in which the active trade or business began (or was acquired). A revised statement may be filed to include any start-up expenditures not included in the taxpayer's original election statement, but the revised statement may not include any expenditures for which the

taxpayer had previously taken a position on a return inconsistent with their treatment as start-up expenditures. The revised statement may be filed with a return filed after the return that contained the election.

(d) *Effective date.* This section applies to elections filed on or after December 17, 1998.

[T.D. 8797, 63 FR 69555, Dec. 17, 1998]

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[T.D. 8867, 65 FR 3826, Jan. 25, 2000]

§ 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]

§ 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.* 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), the existence of a favorable credit rating, 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 (c) of this section, including the exception in paragraph (c)(6) of this section for certain rights to receive tangible property or services from another person.

(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 reinsurance transactions*—(i) *In general.* Section 197 applies to any insurance contract acquired from another person through an assumption reinsurance transaction. For purposes of section 197, an assumption reinsurance transaction is—

(A) Any arrangement in which one insurance company (the reinsurer) becomes solely liable to policyholders on contracts transferred by another insurance company (the ceding company); and

(B) Any acquisition of an insurance contract that is treated as occurring by reason of an election under section 338.

(ii) *Determination of adjusted basis*—(A) *Acquisitions (other than under section 338) of specified insurance contracts.* The amount taken into account for purposes of section 197 as the adjusted basis of specified insurance contracts (as defined in section 848(e)(1)) acquired in an assumption reinsurance transaction that is not described in paragraph (g)(5)(i)(B) of this section is equal to the excess of—

(*1*) The amount paid or incurred (or treated as having been paid or incurred) by the reinsurer for the purchase of the contracts (as determined under § 1.817–4(d)(2)); over

(*2*) The amount of the specified policy acquisition expenses that are attributable to the reinsurer's net positive consideration for the reinsurance agreement (as determined under § 1.848–2(f)(3)).

(B) *Insolvent ceding company*. The reduction of the amount of specified policy acquisition expenses by the reinsurer with respect to an assumption reinsurance transaction with an insolvent ceding company where the ceding company and reinsurer have made a valid joint election under section 1.848–2(i)(4) is disregarded in determining the amount of specified policy acquisition expenses for purposes of this paragraph (g)(5)(ii).

(C) *Other acquisitions.* [Reserved]

(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

(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.

(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), 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.

[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]

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÷320×$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 in the Finding Aids section of this volume.

§ 1.214–1 Expenses for the care of certain dependents incurred during taxable years beginning before January 1, 1972.

(a) *General rule.* (1) This section applies only for expenses incurred during taxable years beginning before January 1, 1972. For expenses incurring in taxable years beginning after December 31, 1971, see section 1.214A, and §§ 214A–1 through 1.214A–5.

(2) Section 214 allows, subject to certain limitations, a deduction from gross income of expenses paid for the care of certain dependents where the care is for the purpose of enabling the taxpayer to be gainfully employed. Such expenses are referred to in this section as ''child care'' expenses. The deduction is allowed only for expenses incurred while the taxpayer is gainfully employed or in active search of gainful employment. The employment which is the cause of the incurring of the expenses may, however, consist of service either within or without the home of the taxpayer. Self-employment constitutes employment for purposes of section 214.

(b) *Taxpayers who may qualify for the deduction.* The deduction provided in section 214 is allowed only to a taxpayer who is a woman, a widower, or, for taxable years beginning after December 31, 1963, a husband whose wife is incapacitated or institutionalized. For purposes of this paragraph, the following rules apply:

(1) *A widower.* The deduction is allowed for expenses paid by a taxpayer who is a widower at the time the expenses are incurred. The term *widower* includes (i) a man whose wife has died and who has not remarried, (ii) a man who is divorced from his wife and has not remarried, and (iii) a man who is legally separated from his wife under a decree of legal separation.

(2) *A married woman whose husband is capable of self-support.* If the expenses are paid by a woman (i) who is married at the time the expenses are incurred, (ii) whose husband at that time is not incapable of self-support because he is mentally defective or physically disabled, (iii) who is not divorced or legally separated at the end of the taxable year, and (iv) in the case of a woman who has been deserted by her

husband and who does not meet all of the conditions set forth in subparagraph (4)(ii) of this paragraph, the deduction is allowed, but only if she files a joint income tax return with her husband for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the taxpayer and her spouse for the taxable year in which the expenses are paid exceeds $4,500 (for taxable years beginning before January 1, 1964) or $6,000 (for taxable years beginning after December 31, 1963). The amount otherwise deductible is the amount expended for child care or the maximum deduction allowable for any taxable year (see paragraph (c) of this section), whichever is the lesser. The determination of whether the taxpayer's husband is incapable of self-support because of a mental defect or physical disability shall be made without regard to his income from sources other than his own earnings. For purposes of this subparagraph, the term *earnings* means wages, salaries, commissions, professional fees, and other amounts received as compensation for personal services actually rendered. It does not include income such as pensions, annuities, sick pay, interest, dividends, or rents.

(3) *A married woman whose husband is incapable of self-support.* (i) The deduction is allowed without regard to the limitations described in subparagraph (2) of this paragraph for expenses paid by a married woman whose husband is incapable of self-support because he is mentally defective or physically disabled (as defined in subparagraph (2) of this paragraph) at the time the expenses are incurred.

(ii) A married woman claiming a deduction under this subparagraph shall submit with her income tax return in which the deduction is claimed information disclosing (*a*) the nature of her husband's disability, (*b*) the period of the disability, (*c*) the amount of her husband's earnings (if any) during the period he was incapable of self-support, and (*d*) such other information as is required by the return or instructions relating to the return. Where the husband is capable of self-support for part of a taxable year the child care expenses incurred for such part shall be treated under subparagraph (2) of this paragraph. See example (8) of paragraph (c)(3)(i) or example (8) of paragraph (c)(3)(ii) (whichever is applicable) of this section.

(4) *A single woman.* (i) The deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who (*a*) is unmarried at the time the expenses are incurred, or (*b*) is, at the close of the taxable year, legally separated from her husband under a decree of divorce or of separate maintenance.

(ii) For taxable years ending after April 2, 1963, the deduction is also allowed without regard to the limitation described in subparagraph (2) of this paragraph for expenses paid by a woman who (*a*) has been deserted by her husband, (*b*) at the time her return for the taxable year is filed, does not know the whereabouts of her husband, (*c*) has not known the whereabouts of her husband at any time during the taxable year, and (*d*) has applied to a court of competent jurisdiction for appropriate process to compel her husband to pay support or otherwise to comply with the law or a judicial order. In general, a wife shall be considered to be deserted by her husband during any period of time during which there is an actual, willful, and voluntary abandonment of the wife by her husband which abandonment is in violation of a legal obligation without legal justification or excuse. The determination as to whether a wife has been deserted by her husband is a question of fact which will not necessarily be governed by provisions of state law relating to desertion or abandonment. The determination as to whether a wife knew the whereabouts of her husband at any particular moment of time will be determined in the light of the particular facts of each case. A wife will be considered to have known the whereabouts of her husband if on a particular day she knew the address at which he was, on such day, residing or carrying on his trade or business, or if she knew the name and address of the person by whom he was employed on such day. A wife will not be considered to have known the whereabouts of her

husband merely because she had information that he was residing or working in a particular city or state. To satisfy the requirement of (d) of this subdivision the wife must have initiated legal proceedings consistent with the applicable state law for the purpose of compelling her husband to pay support or, upon failure of the husband to comply with an order or decree of a court requiring the payment of support, must have initiated legal proceedings, consistent with the applicable state law, for the purpose of requiring compliance by the husband of the order or decree of the court. As used in this subdivision, the term *legal proceedings* includes criminal and quasi criminal proceedings as well as civil proceedings.

(5) *A husband whose wife is incapacitated or institutionalized*—(i) *In general.* Subject to certain limitations, the deduction is allowed for expenses paid in a taxable year beginning after December 31, 1963, by a husband if the expenses are incurred during a period in which his wife is incapacitated. However, the deduction is allowed only if the wife is incapacitated for a period of at least 90 consecutive days or a shorter period if the period of incapacitation is terminated by her death. The period of incapacitation need not occur entirely within one taxable year.

(ii) *Limitation on deduction.* Except as otherwise provided in this subdivision, the deduction is allowed only if the husband files a joint income tax return with his wife for the taxable year in which the expenses are paid. Further, the amount otherwise deductible shall be reduced by the amount, if any, by which the combined adjusted gross income of the husband and his spouse exceeds $6,000 for the taxable year in which the expenses are paid. The amount otherwise deductible is the amount expended for child care (and incurred during the period the wife was incapacitated) or the maximum deduction allowable for any taxable year beginning after December 31, 1963 (see paragraph (c) (2) of this section), whichever is the lesser. The limitations set forth in this subdivision do not apply to any expenses incurred in any period during which the taxpayer's wife is institutionalized if (*a*) the institutionalization is for a period of at least 90 consecutive days, or (*b*) the period of institutionalization (regardless of its length) is terminated by her death. The period of institutionalization referred to in subdivision (*a*) or (*b*) of this subdivision need not occur entirely within one taxable year.

(iii) *Incapacitated wife.* A wife is considered to be incapacitated during any period of time during which she is incapable of caring for herself because of a mental or physical defect. A wife is not considered to be incapacitated solely by reason of the fact that she has a mental or physical defect. A wife is incapacitated only if she is mentally or physically defective and as a result of the mental or physical defect is incapable of caring for herself. The fact that a wife, by reason of a mental or physical defect, is incapable of self-support, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a housewife or to care for her minor children, does not, of itself, establish that the wife is incapable of caring for herself. A wife who is mentally or physically defective to the extent that she cannot dress herself or cannot provide for her personal hygienical or nutritional needs will, ordinarily, be considered as incapable of caring for herself. Thus, a wife who because of an injury (whether temporary or permanent) is confined to a bed or to a wheel chair, even though otherwise enjoying good health, is incapable of caring for herself. In addition, a wife who is physically handicapped, or a wife who is mentally defective and has suicidal or other dangerous tendencies, and for such reason requires constant attention of another person is considered to be incapable of caring for herself. A wife is also considered to be incapacitated during any period of time (whether or not for 90 consecutive days) during which she is institutionalized.

(iv) *Institutionalized wife.* A wife is considered to be institutionalized only while she is, for purposes of receiving medical care or treatment, an inpatient, resident, or inmate of a public or

private hospital, or other similar institution. A wife who resides at a hospital, sanitarium, or other similar institution other than for purposes of receiving medical care or treatment, as, for example, by reason of her employment, is not institutionalized. Generally, a wife is not considered institutionalized while residing at a health or beauty ranch or similar establishment even though some medical care or treatment is provided.

(v) *Information to be submitted with return.* A married man claiming a deduction under this subparagraph shall submit with his income tax return in which the deduction is claimed information disclosing, if his wife is institutionalized, the period of institutionalization and the name and address of the institution where the wife received medical care or treatment, or, if his wife is incapacitated (but not institutionalized), the nature and period of her incapacitation. There shall also be submitted such other information as is required by the return or instructions relating to the return. In addition, there should be submitted, wherever possible, a certificate of the attending physician indicating the nature and duration of the wife's mental or physical defect.

(vi) *Computation of 90-day period—(a) Incapacitation.* For the purpose of determining whether a wife is incapacitated for a period of at least 90 consecutive days, different periods of incapacitation which are separated by a period of time during which the wife is not incapacitated cannot be added together. Thus, if a wife is incapacitated during the months of March and April (61 days) and is incapacitated during the entire month of October (31 days), she is not incapacitated for a period of at least 90 consecutive days. Since a wife who is institutionalized is considered to be incapacitated, the period during which a wife is institutionalized is added to a consecutive period during which she is incapacitated (but not institutionalized) for the purpose of determining whether the wife is incapacitated for a period of at least 90 consecutive days. Thus, the 90-consecutive-day requirement is met where a wife remains at home unable to care for herself because of a mental or physical defect for 60 consecutive days and immediately thereafter enters an institution where she continuously remains for an additional 30 days receiving medical care or treatment, whether or not she is able to care for herself during such 30 days.

(*b*) *Institutionalization.* For the purpose of determining whether a wife is institutionalized for a period of at least 90 consecutive days, different periods of institutionalization which are separated by a period of time during which the wife was not institutionalized cannot be added together. Thus, if a wife is institutionalized during the months of March and April (61 days), spends the months of May and June at home, and is institutionalized during the entire month of July (31 days), she is not institutionalized for a period of at least 90 consecutive days. However, if the wife is incapacitated during all of May and June, the entire period (March through July) constitutes a continuous period of incapacitation, see subdivision (*a*) of this subdivision. The running of a period of institutionalization is not discontinued because of, but rather such period includes, brief absences from the institution such as on weekends or holidays, and transfers from one institution to another.

(vii) *Rule where period of incapacitation does not occur in one taxable year.* The 90-consecutive-day period of incapacitation or of institutionalization need not occur entirely within one taxable year. If part of a period of at least 90 days of incapacitation, or part of a period of incapacitation of less than 90 days which is terminated by reason of the death of the wife, occurs in one taxable year and the remainder occurs in the succeeding taxable year, a deduction is allowed for the child care expenses incurred during the part of the period occurring in each such year, subject, however, to all other conditions and limitations. However, no deduction is allowed for expenses paid in any taxable year which begins before January 1, 1964 (see subdivision (i) of this subparagraph).

(6) *Determination of status.* If child care expenses are incurred in one taxable year and paid in another, the status of a taxpayer described in subparagraphs (1) to (5) of this paragraph, inclusive, shall be determined as of the time at which the expenses are incurred and not when such expenses are paid.

(c) *Computation of deduction*—(1) *In general.* The deduction for child care expenses is allowable only with respect to such expenses actually paid during the taxable year regardless of when the event which occasioned the expenses occurred and regardless of the method of accounting employed by the taxpayer in making his income tax return. If child care expenses are incurred but not paid during the taxable year, no deduction can be taken for such year. Thus, if an expenditure was incurred in December of a particular year, but not paid until January of the following calendar year, no deduction may be taken for the earlier calendar year.

(2) *Dollar limitation on amount of deduction*—(i) *Taxable years beginning before January 1, 1964.* For any taxable year beginning before January 1, 1964, the deduction for child care expenses may not exceed $600 regardless of the number of dependents for whose care the expenses are incurred.

(ii) *Taxable years beginning after December 31, 1963.* Except as otherwise provided in this subdivision, the deduction for child care expenses, for any taxable year beginning after December 31, 1963, may not exceed $600. If the taxpayer has two or more dependents at any time during the taxable year, the $600 limit is increased by the amount of child care expenses incurred by the taxpayer for the period or periods during which the taxpayer has two or more dependents. The $600 limit may not be increased to an amount in excess of $900. For a further limitation on the amount of the allowable deduction, see subparagraphs (2) and (5) of paragraph (b) of this section.

(3) *Examples.* The following examples illustrate the computation of the deduction allowed by section 214 in the case of a taxpayer making his return on the basis of the calendar year. In each example it is assumed that the expenses are of the type which would qualify for the deduction.

(i) The following examples apply to taxable years beginning before January 1, 1964:

Example 1. M was a widower during 1954, until September 1, when he remarried. He paid $50 each month in 1954 for child care expenses. He may take into account, for purposes of the deduction allowed by section 214, only the expenses paid during the taxable year which were incurred while he was unmarried. Since the expenses were $400 ($50 per month from January to August, inclusive), the amount of the deduction is $400. If M had paid $100 per month during 1954, the deduction would be limited to $600, although the expenses incurred while M was unmarried amount to $800.

Example 2. H and W were married during the entire year 1954. W, the wife, paid $900 for child care expenses incurred during the year. The combined adjusted gross income of H and W for 1954 was $5,000. The allowable deduction under section 214 is $100 ($600, the maximum deduction allowable, reduced by $500, the excess of adjusted gross income of $5,000 over $4,500). The deduction of $100 is allowable only if H and W made a joint return for 1954.

Example 3. The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, is less than $500 (the excess of the adjusted gross income over $4,500).

Example 4. During 1954, W, a woman, paid $50 each month for child care expenses. She was unmarried until April 1, 1954, and was married for the remainder of the year. H, her husband, was capable of self-support, and the combined adjusted gross income of husband and wife was $4,700. H and W made a joint return for 1954. The total deduction allowable to W under section 214 is $400, computed as follows: $150 as expenses incurred while W was a single woman, and $250 as expenses incurred while W was married; the $250 is arrived at by taking the amount expended while H and W were married, $450, and reducing it by $200 (the excess of adjusted gross income, $4,700 over $4,500).

Example 5. The facts are the same as in example (4), except that the amounts paid are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400 of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the

amount expended during the period) is reduced to $600 (the maximum deduction allowable) and $600 is then reduced by $200 (the excess of adjusted gross income $4,700 over $4,500) to $400.

Example 6. H and W were married during 1954 prior to July 1, when they received a decree of divorce. She did not remarry during 1954. W paid $100 per month for child care expenses during 1954. The allowable deduction is $600. Since W is considered to have been a single woman during all of 1954, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the $600 limitation applies.

Example 7. H and W married on July 1, 1954. At all times in 1954, until July 1, H was a widower and W was a widow. H and W each paid $750 for child care in 1954, prior to their marriage. Each is allowed a deduction for 1954 of $600, regardless of their adjusted gross income and of the amount of their child care expenditures while married, and whether or not a joint return was filed. However, no additional deduction would be allowed for child care expenses paid after their marriage.

Example 8. H and W were married at all times during the year 1954. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1954 until September 1. The adjusted gross income of H and W for 1954 was $4,700. W paid $60 each month in 1954 for child care expenses. The deduction allowable to W by section 214 is $520. This amount is composed of $480, representing the amounts paid during H's period of disability, and $40, representing the allowable deduction of expenses paid in the amount of $240 from September to December, inclusive ($240 is reduced by $200, the excess of the adjusted gross income ($4,700) over $4,500).

Example 9. H and W were married from January 1, 1954 to October 1, 1954, when H died. The combined adjusted gross income of the spouses was $4,800. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300 which includes $150 deductible as a married woman (the amount expended during marriage, $450, being reduced by $300, the excess of $4,800 over $4,500).

(ii) The following examples apply to taxable years beginning after December 31, 1963:

Example 1. B was a widower during 1964, until August 1, when he remarried. He had two dependent children aged 7 and 10. He paid $90 each month in 1964 for child care expenses. His wife was not incapacitated or institutionalized at any time during 1964. He may take into account, for purposes of the deduction allowed by section 214, only those expenses paid during the taxable year which were incurred while he was unmarried. Therefore, the amount of the deduction allowable is $630 ($90 per month from January to July, inclusive). If B had only one dependent during the period he was unmarried, the amount of the deduction allowable would be limited to $600.

Example 2. H and W were married during the entire year 1964. They have one dependent child age 11. W, the wife, paid $800 for child care expenses incurred during the year. The combined adjusted gross income of H and W was $6,400. The allowable deduction under section 214 is $200, computed as follows: $600, the maximum deduction allowable for one dependent, is reduced by $400, the excess of adjusted gross income ($6,400) over $6,000. The deduction of $200 is allowable only if H and W made a joint return for 1964.

Example 3. The facts are the same as in example (2), except that the child care expenses paid during the year were $400. No deduction is allowable under section 214, since the amount of expenses paid, $400, does not exceed the excess of the adjusted gross income ($6,400) over $6,000.

Example 4. During 1964, W, a woman paid $60 each month for child care expenses for her dependent child age 11. She was a widow from January 1, through March 31, and was married for the remainder of the year. H, her husband, was capable of self-support, and the combined adjusted gross income of H and W for 1964 was $6,200. H and W made a joint return for 1964. The total deduction allowable to W under section 214 is $520, computed as follows: $180, as expenses incurred while W was a single woman, plus $340, as expenses incurred while W was married. The $340 is arrived at by reducing the amount expended while H and W were married, $540, by $200 (the excess of adjusted gross income ($6,200) over $6,000).

Example 5. The facts are the same as in example (4), except that the amounts paid for child care expenses are $75 per month ($225 being paid for expenses incurred while W was single and $675 while she was married). The total allowable deduction in this case is $600. $225 is deductible as expenses incurred while W was a single woman. $400 of the expenses incurred during the period of marriage is also deductible. However, the maximum deduction allowable to W is $600. The allowable amount for expenses incurred during the period of marriage is determined as follows: $675 (the amount expended during such period) is reduced to $600 (the maximum deduction allowable for one dependent) and $600 is then reduced by $200 (the excess of adjusted gross income ($6,200) over $6,000) to $400.

Example 6. H and W were married during 1964 prior to July 1, when they received a decree of divorce. W did not remarry during

1964. She had two dependent children age 6 and 8. W paid $100 per month for child care expenses during 1964. The allowable deduction is $900. Since W is considered to have been a single woman during all of 1964, the limitations with respect to the deduction allowed to a married woman are not applicable, and only the maximum dollar limitation applies ($900 for two dependents for the entire year). If W had only one dependent during the entire year, the allowable deduction would be limited to $600.

Example 7. H and W were married on July 1, 1964. At all times in 1964, until July 1, H was a widower and W was a widow. H and W each paid $600 for child care expenses in 1964, prior to their marriage. W had a dependent child age 6, and H had a dependent child age 8. Their combined adjusted gross income for 1964 was $6,400, and they made a joint return. From July 1, to the end of 1964, W paid $100 per month for child care expenses for both children. If a joint return is not made, H and W are each allowed a deduction of $600, regardless of their adjusted gross income, but no additional deduction would be allowed for child care expenses paid after their marriage. If a joint return is made, H is allowed a deduction of $600 for the expenses paid by him as a widower, and W is allowed a deduction of $800, computed as follows: $600 for expenses paid by her as a widow, and $200 for expenses incurred and paid by her after her marriage. The $200 is arrived at by reducing the amount expended by W from July 1, to the remainder of 1964 (when she had two dependents), $600, by $400, the excess of the adjusted gross income ($6,400) over $6,000. If after her marriage W had incurred and paid child care expenses in the amount of $1,000, W would be allowed a deduction of $900, computed as follows: $600 for expenses paid by her as a widow, and $300 for expenses incurred and paid by her after her marriage. The $300 is arrived at by reducing the $1,000 to $900 (the maximum deduction allowed for two dependents) and the $900 is reduced by $400 (the excess of adjusted gross income, $6,400 over $6,000); and the remainder, $500, is then reduced to $300, which represents the difference between the maximum dollar limitation for two dependents ($900) and the amount paid by W as a widow, $600.

Example 8. H and W were married at all times during 1964. As a result of an accident, H incurred injuries which rendered him incapable of self-support during 1964 until September 1. They had one dependent child age 10. The adjusted gross income of H and W for 1964 was $6,200. W paid $60 each month in 1964 for child care expenses. The deduction allowable to W under section 214 is $520. This amount is composed of $480, the amounts paid during H's period of disability and $40, the expenses paid from September to December, inclusive ($240) reduced by $200, the excess of the adjusted gross income ($6,200) over $6,000.

Example 9. H and W were married from January 1, 1964, until October 1, 1964, when H died. H and W had one child age 10. The combined adjusted gross income of H and W was $6,300. W paid $50 per month for child care expenses throughout the entire year. The deduction allowed to W if she filed a separate return is $150, the amount paid while she was a widow. If a joint return is filed on behalf of the widow and her deceased husband, the deduction allowable is $300, computed as follows: $150 for expenses incurred while W was a widow, and $150 for expenses incurred while W was married (the amount expended during marriage, $450, is reduced by $300, the excess of the adjusted gross income ($6,300) over $6,000).

Example 10. H and W were married at all times during 1964 and have two children. On March 1, 1964, the older child attained age 13 and during the remainder of the year was not a dependent as defined in section 214(d)(1). W incurred and paid $90 each month for child care expenses. H and W's adjusted gross income for 1964 was $6,100, and they made a joint return. The deduction allowable to W under section 214 is $680, computed as follows: $900 (the amount expended from March 1, to the end of 1964) is reduced to $600 (the maximum amount allowable for one dependent) to which is added $180 (the amount expended while H and W had two dependent children under age 13); a total of $780, which amount is reduced by $100 (the excess of the adjusted gross income ($6,100) over $6,000).

Example 11. H and W were married during the entire year 1964 and have two dependents. On March 1, 1964, W became incapacitated and remained unable to care for herself until April 1, 1964, at which time she was admitted to a hospital for medical treatment. W remained in the hospital continuously until June 1, 1964, at which time she returned home. On June 1, 1964, and for the remainder of 1964, W was capable of caring for herself. H incurred and paid $90 a month for child care expenses during 1964. H and W's adjusted gross income for 1964 was $6,100, and they made a joint return for 1964. For purposes of section 214, W is considered to be incapacitated from March 1, 1964 to May 31, 1964, inclusive (a period of at least 90 consecutive days). The allowable deduction is $170, computed as follows: $270, the amount incurred while W was incapacitated, is reduced by $100, the excess of adjusted gross income ($6,100) over $6,000).

Example 12. The facts are the same as in example (11), except that W was in the hospital until August 1, 1964. On August 1, 1964, and for the remainder of 1964, W was capable of caring for herself. The allowable deduction is $360 (the amount incurred while W was institutionalized). No deduction is allowed for the $90 of expenses incurred during March, 1964,

because such amount is less than $100 (the excess of the adjusted gross income ($6,100) over $6,000).

(d) *Dependents*—(1) *In general.* The deduction provided by section 214 is allowed only for expenses paid for the care of an individual who (for the taxable year of the taxpayer in which the expenses are incurred) is a dependent of the taxpayer for whom an exemption is allowed under section 151(e)(1). Furthermore, the dependent must, at the time the expenses are incurred, be:

(i) For taxable years beginning before January 1, 1964, under the age of 12 years,

(ii) For taxable years beginning after December 31, 1963, under the age of 13 years, or

(iii) Mentally or physically unable to care for himself.

(2) *Special rules.* (i) It is not necessary that the dependent be permanently disabled in order for the amount expended for his care to be deductible. However, the mere fact that the disability, whether temporary or permanent, renders him incapable of self-support does not necessarily mean that he is incapable of self-care within the meaning of subparagraph (1)(iii) of this paragraph.

(ii) A dependent who has not attained the age of 13 years (for taxable years beginning before January 1, 1964, who has not attained the age of 12 years) is deemed mentally or physically unable to care for himself. Thus, the deduction for expenses paid for the care of a dependent under the age of 13 years (for taxable years beginning before January 1, 1964, under the age of 12 years) is allowable even though the dependent is not a child or stepchild of the taxpayer.

(iii) The rules provided in sections 151 and 152, with respect to the definition and qualification of an individual as a dependent, govern for the purpose of section 214. Thus, expenses for the care of a child or stepchild under the age of 13 years (for taxable years beginning before Jan. 1, 1964, under the age of 12 years) whom the taxpayer supports are deductible even though the child or stepchild 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. On the other hand, expenses for the care of an aged parent would not be deductible if the gross income condition of §1.151–2 is not met.

(iv) The term *dependent* does not include the spouse of a taxpayer.

(e) *Payments to a dependent.* No deduction is allowed under section 214 for expenses paid to an individual for whom the taxpayer is allowed, for the taxable year in which the expenses are paid, an exemption under section 151. Thus, if the taxpayer, a working widow, supports her mother and is entitled to claim her as a dependent, she may not deduct amounts paid to the mother for the care of the taxpayer's children.

(f) *What expenses are deductible*—(1) *In general.* In order for an expense to be deductible under section 214, it must meet three conditions: First, the expense must be for the care of a dependent; second, it must be for a dependent's care while the taxpayer is gainfully employed or in search of gainful employment; and third, the expense must be for the purpose of enabling the taxpayer to be gainfully employed. In determining whether an expense meets these conditions, all the facts and circumstances of the case must be taken into consideration.

(2) *Definition of care of a dependent.* (i) In general, the phrase *expenses for the care of a dependent* means amounts expended for the primary purpose of assuring the dependent's well being and protection. It does not include all benefits which may be bestowed upon him. Accordingly, amounts expended to provide food, clothing, or education, are not, in themselves, amounts expended for ''care'' so as to be deductible under section 214. However, where the manner of providing care is such that the expense which must be incurred includes payments for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, the full amount paid to a nursery school will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits.

(ii) The manner of providing the care need not be the least expensive method available to the taxpayer. For example, the taxpayer's mother may reside at

the taxpayer's home and be available to afford the taxpayer's child adequate care. Regardless of this fact, the expense incurred for the child at a nursery school or day camp may be expense for the care of the child. See, however, subparagraph (4) of this paragraph with respect to the requirement that the expense must be for the purpose of enabling the taxpayer to be gainfully employed.

(iii) Where a portion of an expenditure is for the care of a dependent and a portion is for other unrelated purposes, a reasonable allocation shall be made and only the portion of the amount paid which is attributable to the care shall be considered an amount to which section 214 is applicable. This rule is applicable if, for example, a servant performs household duties and also cares for the children of the taxpayer. In this case, however, where one of the children is under 13 (for taxable years beginning before January 1, 1964, under 12), and the other (or others) is over such age, there need be no further allocation between the children under such age and those over such age.

(3) *Period of employment.* Since the deduction is allowed only for expenses for care for those periods during which the taxpayer is gainfully employed (or in active search of gainful employment), an allocation may be required when an expense covers periods of care in which no employment is involved. Thus, if a taxpayer pays $50 each month during the year for care of his child at a foster home, and the taxpayer is employed (or in search of employment) for only two months during the year, the deduction is limited to $100.

(4) *Purpose of expenditure.* Even if an expense is incurred for the care of a dependent, it is not deductible unless it is incurred for the purpose of permitting the taxpayer to be gainfully employed. Whether that is the true purpose of the expense depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a dependent is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed.

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

Example 1. A widow has a child who is too young to attend public school. In order that she may be gainfully employed, the widow places the child in a nursery school while she is at work. The expenses paid to the nursery school are child care expenses to which the deduction under section 214 is applicable. Assuming the nursery school provides lunch for the child, no allocation is required between that part of the expense which might be considered to be for the lunch as distinguished from the expense of assuring the child's protection.

Example 2. The taxpayer, a single woman, in order to be gainfully employed employs a housekeeper who cares for the taxpayer's two children, aged 9 and 13 years, respectively, in addition to performing regular household duties of cleaning and cooking. If it is assumed that the compensation paid to the housekeeper is $1,200 during the year, and that $500 is allocated to the care of the children, a deduction of $500 is allowed under section 214. No allocation is required for purposes of determining which part of the $500 is for the care of the 9 year old child. If the expenses allocable to the care of the children were $700, the amount of the deduction would be $600, the maximum amount allowable for one dependent.

Example 3. The taxpayer, a single woman, has a dependent grandchild 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if arrangements are made for the care of the child from 8 a.m. to 5:30 p.m. Such arrangements are made at a private school to which she sends the child. The expenses paid to the school are for the care of the child without allocation between that part of the expense which represents tuition and that part which represents true care. The expense is considered to be incurred for the purpose of enabling the taxpayer to be gainfully employed.

Example 4. The taxpayer, a widow with a substantial income, has a child aged 11 who has been attending boarding school for several years. The taxpayer, who has been performing gratuitous services for a philanthropic organization, accepts a part-time job with the organization for which she is paid a small salary. From these facts it would appear that the expense of continuing the child in the boarding school is not for the purpose of enabling the taxpayer to be gainfully employed, whether or not the expense is considered to be incurred for the care of the child.

Example 5. The taxpayer, a widower, has a child who is physically incapable of caring for himself. In order to be gainfully employed the taxpayer sends the child to a

school for children who are physically handicapped. The expense of the school, whether a day school or a boarding school, is a child care expense.

Example 6. The taxpayer, a single woman, lives with her mother who is an invalid incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother while the taxpayer is at work. The expense paid to the nurse may be a ''child care'' expense.

(g) *Expenses qualifying under section 213.* (1) An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also, as in example (6) of paragraph (f) of this section, constitute an expense for which a deduction is allowable under section 214. In such a case, that part of the amount for which a deduction is allowed under section 214 shall not be treated as an expense under section 213.

(2) On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it shall not be allowed as a deduction under section 214.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example 1. W, a single woman, pays $720 during the taxable year for the care of her child who suffers from infantile paralysis. It is assumed that the expenses are of a nature which qualify as medical expenses under section 213. It is also assumed that these expenses are for the purpose of permitting W to be gainfully employed. W's adjusted gross income for the taxable year is $5,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance of the expenses, or $120, she treats as medical expenses. However, this amount does not exceed 3 percent of her adjusted gross income and is thus not allowable as a deduction under section 213.

Example 2. It would not be proper in the case presented in (1) for W first to determine under section 213 her deductible medical expenses (which would be $570 ($720 less 3% × $5,000)), and then claim as a deduction under section 214 the $150 which is not deductible under section 213. The $150 would be disallowed under section 214 for the reason that it was treated as a medical expense in determining the amount deductible under section 213.

Example 3. W, a single woman under the age of 65 years, is also the head of a household. She pays $12,000 during the taxable year for child care expenses which also qualify as medical expenses under section 213. W's adjusted gross income for the taxable year is $18,000. She is allowed a deduction of $600 for child care expenses under section 214. The balance, or $11,400, is treated as medical expenses. The allowable deduction under section 213 for such expenses is the excess of 3 percent of W's adjusted gross income, or $10,860, but subject to the maximum limitation in section 213.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6740, 29 FR 7715, June 17, 1964; T.D. 6778, 29 FR 17900, Dec. 17, 1964; T.D. 7114, 36 FR 9020, May 18, 1971; T.D. 7411, 41 FR 15404, Apr. 13, 1976; T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–1 Certain expenses to enable individuals to be gainfully employed incurred during taxable years beginning after December 31, 1971, and before January 1, 1976.

(a) *In general.* (1) For expenses incurred during taxable years beginning after December 31, 1971, and before January 1, 1976, section 214 allows (subject to the requirements of this section and §§ 1.214A–2 through 1.214A–5) a deduction for employment-related expenses (as defined in paragraph (c) of this section) which are paid during the taxable year by an individual who maintains a household (within the meaning of paragraph (d) of this section) that includes as a member one or more qualifying individuals (as defined in paragraph (b) of this section). The deduction for expenses allowed under section 214 may be taken only as an itemized deduction and may not be taken into account in determining adjusted gross income under section 62. No deduction shall be allowed under section 214 in respect of any expenses incurred during a taxable year beginning after March 29, 1975, and before January 1, 1976, for which the taxpayer's adjusted gross income is $44,600 or more (or incurred during a taxable year beginning after December 31, 1971, and before March 30, 1975, for which the taxpayer's adjusted gross income is $27,600 or more). Expenses which are taken into account in determining the deduction under section 214:

(i) Must first be reduced by that amount by which a disabled dependent's (age 15 or over) adjusted gross income and nontaxable disability payments for the taxable year exceed $750 or by the total amount of a disabled

spouse's nontaxable disability payments (see section 214(e)(5) and § 1.214A–3),

(ii) Are then disallowed to the extent that, for any calendar month, they exceed $400, determined after taking into account the $200 (or more) per calendar-month limitation on the amount of expenses incurred outside the household for the care of a dependent (or dependents) under the age of 15 (see section 214(c)(1) and (2) and § 1.214A–2 (a) and (b)), and

(iii) Finally, when the taxpayer's adjusted gross income for the taxable year exceeds the sum of $35,000 (or $18,000 in the case of a taxable year beginning after December 31, 1971, and before March 30, 1975), must be further reduced, on a monthly basis, by one-half of the amount by which the adjusted gross income for the calendar year exceeds such sum (see section 214(d) and § 1.214A–2(c)).

(2) The deduction for employment-related expenses is allowable only for such expenses as are actually paid during the taxable year regardless of when the event which occasions the expenses occurs and of the taxpayer's method of accounting. If such expenses are incurred but not paid during the taxable year, no deduction may be taken for such year. Thus, if such an expense is incurred in the last month of a taxable year but not paid until the following taxable year, a deduction for such expense shall not be allowed for the earlier taxable year. However, if the requirements for deductibility, other than payment, are satisfied in the last month of the taxable year, and the item is paid in the following taxable year, a deduction is allowed under section 214 for such following taxable year.

(3) The requirements of section 214, this section, and §§ 1.214A–2 through 1.214A–5 are to be applied to such expenses as of the time they are incurred regardless of when they are paid.

(4) For special rules relating to the deduction of employment-related expenses which may also qualify as medical expenses deductible under section 213, see § 1.214A–5(b).

(5) For substantiation of the deduction, see paragraph (e) of this section.

(b) *Qualifying individual*—(1) *In general.* A person is considered to be a qualifying individual if he is either (i) the taxpayer's dependent who is under the age of 15 and is an individual for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e); (ii) the taxpayer's dependent (not described in subdivision (i)) who is physically or mentally incapable of caring for himself; or (iii) the taxpayer's spouse who is physically or mentally incapable of caring for himself. The term *dependent,* as used in this subparagraph, includes any individual who is a dependent within the meaning of section 152. For the rules for determining which parent may claim a child as a dependent where the parents are divorced, legally separated, or separated under a written separation agreement, see section 152(e) and the regulations thereunder.

(2) *Qualification on a daily basis.* The status of a person as a qualifying individual will be determined on a daily basis. Thus, if a dependent or spouse of a taxpayer ceases to be a qualifying individual on September 16, the dependent or spouse will be treated as a qualifying individual through September 15 only.

(3) *Physical or mental incapacity.* An individual will be considered to be physically or mentally incapable of caring for himself if as a result of a physical or mental defect he is incapable of caring for his hygienical or nutritional needs, or requires full time attention of another person for his own safety or the safety of others. The fact that an individual, by reason of a physical or mental defect, is unable to engage in any substantial gainful activity, or is unable to perform the normal household functions of a homemaker or to care for minor children, will not of itself establish that the individual is physically or mentally incapable of caring for himself. An individual who is physically handicapped or is mentally defective, and for such reason requires constant attention of another person, is considered to be physically or mentally incapable of caring for himself.

(c) *Employment-related expenses*—(1) *Gainful employment*—(i) *In general.* Expenses are considered to be employment-related expenses only if they are

incurred to enable the taxpayer to be gainfully employed and are paid for household services or for the care of one or more qualifying individuals. The expenses must be incurred while the taxpayer is gainfully employed or is in active search of gainful employment. The employment may consist of service either within or without the home of the taxpayer and may include self-employment. Unpaid volunteer work or work for a nominal salary does not constitute qualifying employment. An expense will not be considered to be employment-related merely because it is incurred while the taxpayer is gainfully employed. Whether the purpose of the expense is to enable the taxpayer to be gainfully employed depends upon the facts and circumstances of the particular case. Thus, the fact that the cost of providing care for a qualifying individual is greater than the amounts anticipated to be received from the employment of the taxpayer may indicate that the purpose of the expenditure is other than to permit the taxpayer to be gainfully employed. Any tax required to be paid by the taxpayer under section 3111 (relating to the Federal Insurance Contributions Act) in respect of any wages which otherwise constitute employment-related expenses shall be considered to be an employment-related expense.

(ii) *Determination of period of employment on a daily basis.* An allocation of expenses is required on a daily basis when such expenses cover any period during part of which the taxpayer is gainfully employed or is in active search of gainful employment and during the other part of which there is no employment or active search for gainful employment. Thus, for example, if a taxpayer incurs during each month of the taxable year $60 of expenses which would be employment-related if he were gainfully employed all year, and the taxpayer is gainfully employed, or in active search of gainful employment, for only 2 months and 10 days during such year, the amount of employment-related expenses is limited to $140. If a taxpayer is married, both he and his spouse must be gainfully employed on a substantially full-time basis (see § 1.214A–4(b)). However, certain married individuals living apart are treated as not married for this purpose (see § 1.214A–4(c)).

(2) *Household services.* Expenses will be considered to be paid for household services if they are paid for the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household. However, expenses will not be considered as paid for household services unless the expenses are attributable in part to the care of the qualifying individual. Thus, amounts paid for the services of a domestic maid or cook will be considered to be expenses paid for household services if a part of those services is provided to the qualifying individual. Amounts paid for the services of an individual who is employed as a chauffeur, bartender, or gardener, however, will not be considered to be expenses paid for household services.

(3) *Care of qualifying individual*—(i) *In general.* The primary purpose of expenses for the care of a qualifying individual must be to assure that individual's well-being and protection. Not all benefits bestowed upon such an individual will be considered as provided for his care. Accordingly, amounts paid to provide food, clothing, or education are not expenses paid for the care of a qualifying individual. However, where the manner of providing care is such that the expense which is incurred includes expense for other benefits which are inseparably a part of the care, the full amount of the expense will be considered to be incurred for care. Thus, for example, the full amount paid to a nursery school in which a qualifying child is enrolled will be considered to be for the care of the child, even though the school also furnishes lunch, recreational activities, and other benefits. Educational expenses incurred for a child in the first or higher grade level are not expenses incurred for the care of one or more qualifying individuals. Expenses incurred for transportation of a qualifying individual described in paragraph (b)(1)(i) of this section between the taxpayer's household and a place outside the taxpayer's household where services for the care of such qualifying individual are provided will not be considered to be incurred for the care of such qualifying individual.

(ii) *Manner of providing care.* The manner of providing the care need not be the least expensive alternative available to the taxpayer. For example, the taxpayer's mother may reside at the taxpayer's home and be available to provide adequate care at no cost for the taxpayer's wife who is physically or mentally incapable of caring for herself. Nevertheless, the expenses incurred in providing a nurse for the wife may be an expense for the care of the wife. See, however, paragraph (c)(1)(i) of this section with respect to the requirement that the expense must be for the purpose of permitting the taxpayer to be gainfully employed.

(4) *Allocation of expenses.* Where a portion of an expense is for household services or for the care of a qualifying individual and a portion of such expense is for other unrelated purposes, a reasonable allocation must be made and only the portion of the expense paid which is attributable to such household services or care will be considered to be an employment-related expense. No such allocation is required to be made, however, if the portion of expense for the unrelated purpose is minimal or insignificant. Such an allocation must be made, for example, if a servant performs household duties, cares for the children of the taxpayer, and also performs social services for the taxpayer (for which a deduction is not allowable) and clerical services in the office of the taxpayer outside the home (for which a deduction may be allowable under section 162). Since a household service expense may be considered employment-related in its entirety even though it is only in part attributable to the care of a qualifying individual, no allocation is required between the part of the household service expense which is attributable to that care of a qualifying individual and that part which is not so attributable.

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

Example 1. The taxpayer lives with her mother who is physically incapable of caring for herself. In order to be gainfully employed the taxpayer hires a practical nurse whose sole duty consists of providing for the care of the mother in the home while the taxpayer is at work. All amounts spent for the services of the nurse are employment-related expenses.

Example 2. The taxpayer has a dependent child 10 years of age who has been attending public school. The taxpayer who has been working part time is offered a position involving full-time employment which she can accept only if the child is placed in a boarding school. The taxpayer accepts the position, and the child is sent to a boarding school. The expenses paid to the school must be allocated between that part of the expenses which represents care for the child and that part which represents tuition for education. The part of the expense representing care of the child is considered to be incurred for the purpose of permitting the taxpayer to be gainfully employed.

Example 3. The taxpayer, in order to be gainfully employed, employs a housekeeper who cares for the taxpayer's two children, aged 9 and 15 years, respectively, performs regular household services of cleaning and cooking, and chauffeurs the taxpayer to and from his place of employment. The chauffeuring service never requires more than 30 minutes out of the total period of employment each day. No allocation is required for purposes of determining the portion of the expense attributable to the chauffeuring (not a household service expense) since it is de minimis. Further, no allocation is required for the purpose of determining the portion of the expense attributable to the care of the 15 year old child (not a qualifying individual) since the household expense is in part attributable to the care of the 9 year old child, who is a qualifying individual. Accordingly, the entire expense of employing the housekeeper is an employment-related expense.

(d) *Maintenance of a household*—(1) *In general.* An individual is considered to have maintained a household for his taxable year (or lesser period) only if he (and his spouse if he is married) have furnished over one-half of the cost incurred for such taxable year (or lesser period) in maintaining the household. The household must actually constitute for the taxable year the principal place of abode of the taxpayer and the qualifying individual or individuals described in paragraph (b) of this section. It is not sufficient that the taxpayer maintain the household without being its occupant. A physical change in the location of the home will not, however, prevent the home from constituting the principal place of abode of the taxpayer and a qualifying individual. The fact that an individual is born or dies during the taxable year

will not prevent a home from constituting his principal place of abode for such year. An individual will not be considered to have terminated a household as his principal place of abode merely by reason of temporary absences therefrom by reason of illness, education, business, vacation, military service, or a custody agreement.

(2) *Two or more families.* Solely for purposes of section 214 and this section, if two or more families occupy living quarters in common, each of such families will be treated as constituting a separate household, and the taxpayer who provides more than one-half of the costs of maintaining such a separate household will be treated as maintaining such household. Thus, for example, if two unrelated women each with children occupy living quarters in common and each woman pays more than one-half of her proportionate share of household costs incurred by both families, each woman will be treated as maintaining her separate household.

(3) *Costs of maintaining a household.* The cost of maintaining a household shall be the expenses incurred for the mutual benefit of the occupants thereof by reason of its operation as the principal place of abode of such occupants. The expenses of maintaining a household include property taxes, mortgage interest, rent, utility charges, upkeep and repairs, property insurance, and food consumed on the premises. Such expenses do not include the cost of clothing, education, medical treatment, vacations, life insurance, or transportation or payments on mortgage principal or for the purchase, permanent improvement, betterment, or replacement of property. However, the cost of maintaining a household shall not include any amount which represents the value of services performed in the household by the taxpayer or by a qualifying individual described in paragraph (b) of this section. Expenses incurred in respect of which money or other property is received as compensation or reimbursement may not be included as a cost of maintaining a household.

(4) *Monthly proration of annual costs.* In determining the cost incurred for a period of less than a taxable year in maintaining a household, the cost incurred during the entire taxable year must be prorated on the basis of the number of calendar months within such lesser period. For this purpose a period of less than a calendar month will be treated as a calendar month. Thus, for example, if the cost of maintaining a household for a taxable year is $6,600, and the period in respect of which a determination is being made under section 214 is from June 20 to December 31, the taxpayer must furnish more than $1,925 ([$6,600×7/12]×50%) in maintaining the household from June 1 to December 31.

(e) *Substantiation.* A taxpayer claiming a deduction under paragraph (a) of this section for employment-related expenses must substantiate by adequate records or other sufficient evidence any deductions taken under this section. For example, if requested, the taxpayer must furnish information as to the nature and period of the physical or mental incapacitation of any dependent or spouse in respect of whom a deduction is claimed, including necessary information from the attending physician as to the nature of the physical or mental incapacity.

[T.D. 7411, 41 FR 5405, Apr. 13, 1976, as amended by T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–2 Limitations on deductible amounts.

(a) *Overall monthly limitation of $400.* The deduction under section 214(a) and § 1.214A–1(a) for employment-related expenses is not allowed in respect of any such expenses in excess of $400 incurred during any one calendar month. For purposes of the limitation of $400, a period of less than a calendar month will be treated as a calendar month. Any amount by which employment-related expenses incurred during any calendar month exceed $400 may not be carried to another calendar month and used in determining the employment-related expenses incurred in such other calendar month. Thus, for example, if a taxpayer incurs employment-related expenses of $500 during each of the first 6 months of the taxable year and only $200 of such expenses during each of the

last 6 months, the amount of his deduction for the payment during such taxable year of such expenses shall be limited by this paragraph to $3,600, consisting of $2,400 ($400×6) incurred during the first 6 months of the taxable year and $1,200 ($200×6) incurred during the last 6 months of the taxable year. The limitation provided by this paragraph must be applied after making the reduction in the amount of employment-related expenses provided by paragraph (a) of § 1.214A–3 (relating to disability payments) and after the application of the limitation upon the amount deductible provided by paragraph (b) of this section.

(b) *Restriction to expenses incurred for services in the household*—(1) *In general.* Except as otherwise provided in paragraph (b)(2) of this section, deduction shall be allowed under § 1.214 A–1(a) only for employment-related expenses incurred for services performed in the household of the taxpayer. Thus, for example, if a taxpayer places his invalid father in a nursing home, he is not entitled to deduct his employment-related expenses incurred for his father's care provided by the nursing home. If, however, the taxpayer's father remains in the home used as the household, the taxpayer is allowed to deduct his employment-related expenses attributable to the employment in the household of a nurse to care for his father.

(2) *Exception for certain expenses incurred outside the household.* A deduction shall be allowed under § 1.214A–1(a) for employment-related expenses incurred for services performed outside the household of the taxpayer only if such expenses are incurred for the care of one or more dependents of the taxpayer who are under the age of 15 and who are persons for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e). The amount of such expenses incurred during a calendar month for services performed outside the household of the taxpayer which may be deducted is limited to:

(i) $200, in the case of one such dependent,

(ii) $300, in the case of two such dependents, or

(iii) $400, in the case of three or more such dependents.

For purposes of the limitation under this subparagraph, a period of less than a calendar month will be treated as a calendar month. Any amount which is taken into account after the application of such limitation is also subject to the monthly limitation of $400 provided by paragraph (a) of this section.

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

Example 1. If during a calendar month a taxpayer incurs employment-related expenses of $150 for services performed within his household and $300 for services performed outside the household for the care of his child, age 5, the taxpayer is entitled to deduct only $350 of such expenses. In such case the $300 for services performed outside the household is limited to $200 by subparagraph (2) of this paragraph.

Example 2. If the facts are the same as in example (1) except that during the month the taxpayer incurs employment-related expenses of $250 for services performed within his household, the taxpayer is entitled to deduct only $400 of the total expenses incurred. In such case the total expenses incurred during the month which may be taken into account ($450) are limited to $400 by paragraph (a) of this section.

(c) *Taxpayer's income limitation*—(1) *In general.* This paragraph applies only if the adjusted gross income of the taxpayer for the taxable year exceeds the amount of $35,000, in the case of a taxable year beginning after March 29, 1975, and before January 1, 1976 (or the amount of $18,000 in the case of a taxable year beginning after December 31, 1971, and before March 30, 1975). In either case, in determining the deduction allowable under § 1.214A–1(a) for employment-related expenses, the amount of such expenses incurred during any calendar month of the taxable year must be reduced by an amount equal to the excess of the adjusted gross income of the taxpayer for the taxable year over the applicable income limitation ($35,000 or $18,000 as the case may be) divided by twice the number of calendar months in the taxable year. For purposes of applying the taxpayer's income limitation a period of less than a calendar month will be treated as a

calendar month. The limitation provided by this paragraph must be applied after making the reduction in the amount of employment-related expenses provided by paragraph (a) of § 1.214A–3 and after the application of the limitations upon the amount deductible provided by paragraph (a) of § 1.214A–3 and after the application of the limitations upon the amount deductible provided by paragraphs (a) and (b) of this section. The application of this subparagraph may be illustrated by the following examples:

Example 1. A, a single individual who uses the fiscal year ending March 31 as the taxable year, incurs (and pays) during May 1975 employment-related expenses of $600. He has adjusted gross income of $41,000 for the fiscal year ending March 31, 1976. Under these circumstances the amount of employment-related expenses for the month of May 1975 which may be taken into account under paragraph (a) of § 1.214A–1 is $150, determined as follows:

Employment-related expenses incurred during May ($600, but not to exceed $400 under par. (a) of this section)	$400
Less: Reduction under this subparagraph:	
Adjusted gross income for taxable year	41,000
Less: Taxpayer's income limitation applicable to taxable year beginning after March 29, 1975	35,000
Excess adjusted gross income over income limitation	6,000
Excess divided by twice the number of calendar months in taxable year ($6,000+[2×12])	250
Employment-related expenses to be taken into account	150

Example 2. Assume the same facts as in example (1) except that A incurs employment-related expenses of only $200 during May 1975. Under these circumstances no amount of employment-related expenses may be taken into account for the month of May under paragraph (a) of § 1.214A–1 because the expenses of $200 for the month are fully offset by the reduction of $250 required under this subparagraph.

Example 3. B, a single individual who uses the calendar year as the taxable year, incurs and pays during June, 1975, employment-related expenses of $500. On August 31, 1975, B dies. His adjusted gross income for the taxable year ending August 31 is $22,800. Under such circumstances the amount of employment-related expenses for the month of June which may be taken into account under paragraph (a) of § 1.214A–1 is $100, determined as follows:

Employment-related expenses incurred during June ($500, but not to exceed $400 under par. (a) of this sec.)	$400
Less: Reduction under this subparagraph:	
Adjusted gross income for taxable year	22,800
Less: Taxpayer's income limitation applicable to taxable year beginning before March 30, 1975	18,000
Excess adjusted gross income over income limitation	4,800
Excess divided by twice the number of calendar months in taxable year ($4,800+[2×8])	300
Employment-related expenses to be taken into account	100

(2) *Marital status.* For purposes of paragraph (c)(1) of this section, the adjusted gross income of the taxpayer for his taxable year shall include the adjusted gross income of his spouse for such year if he is married for the entire taxable year. If the taxpayer is married during only a part of his taxable year, his adjusted gross income for the taxable year shall include the adjusted gross income of his spouse for only such period within the taxable year during which he is married. Thus, if the taxpayer and his wife use the calendar year as the taxable year and the taxpayer's wife dies on May 15 and he does not remarry before the close of his taxable year, the adjusted gross income of the wife for the period from January 1 to May 15 must be included in applying the income limitation for the taxable year under section 214(d) and paragraph (c)(1) of this section. If, however, in such case the taxpayer were to remarry on October 15 of his taxable year and file a single return jointly with the second wife, the adjusted gross income of the first wife for the period from January 1 to May 15 and the adjusted gross income of the second wife for the period from October 15 to December 31 must be included in applying the income limitation for the taxable year under paragraph (c)(1) of this section.

[T.D. 7411, 41 FR 15407, Apr. 13, 1976, as amended by T.D. 7643, 44 FR 50337, Aug. 28, 1979]

§ 1.214A–3 Reduction of expenses for certain disability payments and adjusted gross income.

(a) *Amount of reduction.* This section applies only if the taxpayer incurs employment-related expenses during a

taxable year solely attributable to a qualifying individual who is either a dependent (other than a dependent described in § 1.214A–1(b)(1)(i)) of the taxpayer or a spouse of the taxpayer and who is physically or mentally incapable of caring for himself. The amount of such expenses, which may be taken into account under section 214 shall be reduced:

(1) In the case of such expenses attributable to a dependent who is physically or mentally incapable of caring for himself, by the excess, if any, over $750 of the sum of (i) such dependent's adjusted gross income for such taxable year and (ii) the disability payments (as defined in paragraph (b) of this section) he receives during such year, and

(2) In the case of such expenses attributable to a spouse who is physically or mentally incapable of caring for himself, by the disability payments (as defined in paragraph (b) of this section) such spouse receives during such taxable year.

The reduction so required must be made on the basis of a calendar month. Thus, the employment-related expenses attributable to a spouse which are incurred during any calendar month of the taxable year must be reduced by an amount equal to the disability payments received by the spouse during such taxable year divided by the number of calendar months therein during which such employment-related expenses are incurred. Further, the employment-related expenses attributable to a dependent which are incurred during any calendar month of the taxable year must be reduced by an amount equal to the excess described in paragraph (a)(1) of this section divided by the number of calendar months therein during which such employment-related expenses are incurred. For purposes of this reduction, a period of less than a calendar month will be treated as a calendar month. The reduction is not required to be made in respect of any employment-related expenses solely attributable to a dependent under the age of 15 for whom the taxpayer is entitled to a deduction for a personal exemption under section 151(e). The reduction required by this paragraph must be made before applying the limitations under section 214 (c) and (d) and § 1.214A–2 for the taxable year. The application of this paragraph may be illustrated by the following examples:

Example 1. A, a taxpayer who uses the calendar year as the taxable year, incurs $250 of employment-related expenses during each month of 1972 for services within his household. B, his wife, is physically incapable of caring for herself. During 1972, B receives total disability payments of $1,200, consisting of a lump-sum disability payment of $300 received in June and disability payments of $75 received each month. Under such circumstances, A may take into account $150 of his employment-related expenses for each month of 1972, determined as follows:

Employment-related expenses attributable to B incurred during each month	$250
Less: Disability payments received by B in 1972 divided by number of calendar months in 1972 during which employment-related expenses attributable to B are incurred ($1,200÷12)	100
Employment-related expenses to be taken into account	150

Example 2. B, a single individual who uses the calendar year as the taxable year, incurs $200 of employment-related expenses during each month of 1972 for services within his household. C, his son aged 15, is physically incapable of caring for himself. During 1972, C receives total disability payments of $1,200, consisting of a lump-sum disability payment of $300 received in June and disability payments of $75 received each month. For 1972, C has adjusted gross income of $1,050. Under such circumstances, B may take into account $75 of his employment-related expenses for each month of 1972, determined as follows:

Employment-related expenses attributable to C incurred during each month	$200
Less: Reduction under this paragraph:	
C's adjusted gross income for 1972	1,050
Disability payments received by C in 1972	1,200
Total	2,250
Less: Income limitation	750
Excess under subparagraph (1) of this paragraph	1,500
Excess divided by number of calendar months in 1972 during which employment-related expenses attributable to C are incurred ($1,500÷12)	125
Employment-related expenses to be taken into account	75

Example 3. H, a taxpayer who uses the calendar year as the taxable year, incurs employment-related expenses attributable to

W, his wife, during five months of 1972, including $350 for the month of July, for services within his household. W, who is physically incapable of caring for herself, receives during 1972 total disability payments of $625. Under such circumstances, H may take into account $225 of his employment-related expenses for July, determined as follows:

Employment-related expenses attributable to W incurred during July	$350
Less: Disability payments received by W in 1972 divided by number of calendar months in 1972 during which employment-related expenses attributable to W are incurred ($625÷5)	125
Employment-related expenses to be taken into account	225

Example 4. S, a single individual who uses the calendar year as the taxable year, incurs and pays during 1972 $450 of employment-related expenses attributable to P, his father, for each of the six months during which his father is incapacitated. During 1972, P receives adjusted gross income of $1,266, a gift of $300, and a disability payment of $55 for each month of disability. During 1972 S receives adjusted gross income of less than $18,000. Under such circumstances, S may deduct $1,854 for 1972 under section 214, determined as follows:

Employment-related expenses attributable to P incurred during each month of his incapacity	$450
Less: Reduction under this paragraph:	
P's adjusted gross income for 1972	1,266
Disability payments received by P in 1972	330
Total	1,596
Less: Income limitation	750
Excess under subparagraph (1) of this paragraph	846
Excess divided by number of calendar months in 1972 during which employment-related expenses attributable to P are incurred ($846÷6)	141
Employment-related expenses to be taken into account for each month of P's incapacity	309
Deduction for 1972 ($309×6)	1,854

(b) *Disability payment defined.* For purposes of paragraph (a) of this section, the term *disability payment* means any payment not includible in gross income which is made on account of the physical or mental incapacity of an individual. A disability payment may include social security payments, State or local payments, private disability insurance payments, or payments from a private person on account of a civil wrong, if attributable to the mental or physical disability of the individual. Gifts are not considered to be disability payments for purposes of this paragraph.

(c) *Expenses not solely attributable.* An employment-related expense which is not solely attributable to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies shall not be reduced under this section. Thus, for example, if household expenses are incurred with respect to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies and also with respect to a qualifying dependent under the age of 15, such expenses shall not be considered to be solely attributable to a qualifying individual to whom paragraph (a) (1) or (2) of this section applies, and such expenses shall not be reduced under this section. The application of this paragraph may be illustrated by the following examples:

Example 1. A taxpayer has a child, aged 6, and his spouse is physically incapable of caring for herself. During the taxable year he incurs employment-related expenses of $500 solely attributable to the care of the child, of $1,000 solely attributable to the care of his spouse, and of $1,500 for household services attributable to both the child and spouse. Of the taxpayer's total employment-related expenses of $3,000, only the $1,000 solely attributable to his spouse must be reduced as provided in paragraph (a) of this section.

Example 2. A taxpayer has a dependent, aged 15, and a spouse both of whom are physically incapable of caring for themselves. During the taxable year he incurs employment-related expenses of $500 solely attributable to the care of the dependent, of $1,000 solely attributable to the care of his spouse, and of $1,500 for household services equally attributable to both the dependent and spouse. The $1,500 of household expenses must be allocated one-half to the dependent and one-half to the spouse. Accordingly, employment-related expenses of $1,250 are attributable to the dependent, and employment-related expenses of $1,750 are attributable to the spouse. The expenses attributable to each must be reduced as provided in paragraph (a) of this section.

(d) *Ordering of reductions and limitations.* For purposes of determining the amount of employment-related expenses which may be taken into account under section 214, the employment-related expenses incurred by the taxpayer during any calendar month of the taxable year are first to be reduced by the amount of reduction determined

under section 214(e)(5) and paragraph (a) (1) or (2) of this section in respect of disability payments and adjusted gross income, then by the outside-of-household limitation prescribed by section 214(c)(2)(B) and § 1.214A–2(b)(2), then by the overall monthly limitation of $400 prescribed by section 214(c)(1) and § 1.214A–2(a), and finally by the taxpayer's income limitation ($35,000 or $18,000, as the case may be) prescribed by section 214(d) and § 1.214A–2(c), in that order. The application of this subparagraph may be illustrated by the following examples:

Example 1. The taxpayer's wife is physically incapable of caring for herself. He incurs employment-related expenses of $1,000 during the calendar month for services within the household. Disability payments of the wife applicable to such month under paragraph (a)(2) of this section amount to $350. The taxpayer's excess adjusted gross income (over the taxpayer's income limitation) applicable to such month under § 1.214A–2(c)(1) amounts to $300. Under such circumstances, the amount of employment-related expenses for such month which may be taken into account for purposes of section 214 is $100, determined as follows:

Employment-related expenses	$1,000
Less: Reduction under paragraph (a)(2) of this section	350
Balance	650
Application of limitation under § 1.214A–2(a) (employment-related expenses of $650, but not to exceed $400)	400
Less: Reduction under § 1.214A–2(c)(1)	300
Employment-related expenses to be taken into account	100

Example 2. The taxpayer's child, aged 15, is physically incapable of caring for himself the taxpayer incurs employment-related expenses of $487 duing June for services within the household. The excess of the adjusted gross income and disability payments of the dependent child for the taxable year (over the $750 limitation) applicable to June under paragraph (a)(1) of this section amounts to $112. The taxpayer's excess adjusted gross income (over the taxpayer's income limitation) applicable to June under § 1.214A–2(c)(1) amounts to $125. Under such circumstances, the amount of employment-related expenses for June which may be taken into account for purposes of section 214 is $250, determined as follows:

Employment-related expenses	$487
Less: Reduction under paragraph (a)(1) of this section	112
Balance	375
Less: Reduction under § 1.214A–2(c)(1)	125
Employment-related expenses to be taken into account	250

[T.D. 7411, 41 FR 15408, Apr. 13, 1976]

§ 1.214A–4 Special rules applicable to married individuals.

(a) *Joint return requirement.* This section applies only if the taxpayer is married at the close of a taxable year in which employment-related expenses are paid. In such a case the deduction provided by section 214(a) and § 1.214A–1(a) for such expenses shall be allowed only if for such taxable year the taxpayer files a single return jointly with his spouse. If either spouse dies during the taxable year and a joint return may be made for such year under section 6013(a)(2) for the survivor and the deceased spouse, the deduction shall be allowed for such year only if a joint return is made. If, however, the surviving spouse remarries before the end of his taxable year in which his first spouse dies, a deduction is allowed under section 214(a) on the separate return which is made for the decedent spouse. For purposes of this section, certain married individuals living apart are treated as not married, as provided in paragraph (c) of this section.

(b) *Gainful employment requirement*—(1) *In general.* The employment-related expenses incurred during any month of any period within the taxable year of a taxpayer who is married for such period shall be taken into account under section 214(a) and § 1.214A–1(a) only if both the taxpayer and his spouse are gainfully employed on a substantially full-time basis or are in active search of gainful employment on a substantially full-time basis, or if his spouse is physically or mentally incapable of caring for herself. For such purposes, an individual is considered to be gainfully employed on a substantially full-time basis if he is employed for three-quarters or more of the normal or customary work week (or the equivalent on the average during a month).

(2) *Determination of qualifying periods on a daily basis.* For purposes of this paragraph, the determination as to whether an individual is gainfully employed on a substantially full-time basis shall be made on a daily basis in

accordance with the provisions of paragraph (c)(1)(ii) of § 1.214A–1, and the determination as to whether a spouse is physically or mentally incapable of caring for himself shall be made on a daily basis in accordance with paragraph (b)(2) of such section. Thus, for example, if a taxpayer is gainfully employed throughout the taxable year on a substantially full-time basis but his spouse ceases on August 17 of such year to be employed on a substantially full-time basis and on November 16 of the same year becomes physically or mentally incapable of caring for herself, an allocation must be made to determine the period ending on August 17 during which both spouses are gainfully employed on a substantially full-time basis, and the incapacitated spouse is to be treated as a qualifying individual described in section 214(b)(1)(C) only for the period commencing with November 16. Employment-related expenses incurred from August 18 through November 15 may not be taken into account since only one spouse is gainfully employed on a substantially full-time basis during such period and the other spouse is not physically or mentally incapable of caring for herself during such period.

(c) *Certain married individuals living apart.* For purposes of section 214 an individual who for his taxable year would be treated as not married under section 143(a)(2), or would be treated as not married under section 143(b) if paragraph (1) of such section referred to any dependent of the taxpayer (and not simply to a son, stepson, daughter, or stepdaughter of such individual), shall be treated as not married for such taxable year. Thus, an individual who is married within the meaning of section 143(a) will be treated as not married for his entire taxable year for purposes of section 214, if:

(1) He files a separate return for such year,

(2) He maintains as his home a household which constitutes for more than one-half of such year the principal place of abode of one or more of his dependents with respect to whom he is entitled to a deduction under section 151 for such year,

(3) He furnishes over one-half of the cost of maintaining such household for such year, and

(4) His spouse is not a member of such household for any part of such year.

Thus, for example, an individual who is married during the taxable year and is living apart from his spouse, but is not legally separated under a decree of divorce or separate maintenance, may, if he is treated as not married by reason of this paragraph, determine the limitation upon the amount of his employment-related expenses without taking into account the adjusted gross income of his spouse under § 1.214A–2(c)(2), without complying with the requirement under paragraph (a) of this section for filing a joint return with his spouse, and without complying with the requirement under paragraph (b) of this section that his spouse be gainfully employed. The principles of § 1.143–1(b) shall apply in making determinations under this paragraph.

[T.D. 7411, 41 FR 15409, Apr. 13, 1976]

§ 1.214A–5 Other special rules relating to employment-related expenses.

(a) *Payments to related individuals.* No deduction will be allowed under section 214(a) and § 1.214A–1(a) for the amount of any employment-related expenses paid by the taxpayer to an individual who bears to the taxpayer any relationship described in section 152(a) (1) through (8). These relationships are those of a son or daughter or descendant thereof; a stepson or stepdaughter; a brother, sister, stepbrother, or stepsister; a father or mother or an ancestor of either; a stepfather or stepmother; a nephew or niece; an uncle or aunt; or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. In addition, no deduction will be allowed under section 214(a) for the amount of any employment-related expenses paid by the taxpayer to an individual who qualifies as a dependent of the taxpayer for the taxable year within the meaning of section 152(a)(9), which relates to an individual (other than the taxpayer's spouse) whose principal place of abode for the taxable year is the home of the taxpayer and who is a member of the taxpayer's household.

(b) *Expenses qualifying as medical expenses.* An expense which may constitute an amount otherwise deductible under section 213, relating to medical, etc., expenses, may also constitute an expense for which a deduction is allowable under section 214(a) and § 1.214A–1(a). In such a case, that part of the amount for which a deduction is allowed under section 214(a) will not be considered as an expense allowable as a deduction under section 213. On the other hand, where an amount is treated as a medical expense under section 213 for purposes of determining the amount deductible under that section, it may not be treated as an employment-related expense for purposes of section 214. The application of this paragraph may be illustrated by the following examples:

Example 1. A Taxpayer pays $520 of employment-related expenses in the taxable year for the care of his child during one month of such year when the child is physically incapable of caring for himself. These expenses are incurred for services performed in the taxpayer's household and are of a nature which qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $5,000. Of the total expenses, the taxpayer may take $400 into account under section 214; the balance of the expenses, or $120, may be treated as medical expenses to which section 213 applies. However, this amount does not exceed 3 percent of the taxpayer's adjusted gross income for the taxable year and is thus not allowable as a deduction under section 213.

Example 2. Assume the same facts as in *Example 1.* In such case it is not proper for the taxpayer first to determine under section 213 his deductible medical expenses of $370 ($520 − [$5,000×3%]) and then claim the $150 balance as employment-related expenses for purposes of section 214. This result is reached because the $150 balance has been treated as a medical expense in determining the amount deductible under section 213.

Example 3. A taxpayer incurs and pays $1,000 of employment-related expenses each month during the taxable year for the care of his child. These expenses are incurred for services performed in the taxpayer's household, and they also qualify as medical expenses under section 213. The taxpayer's adjusted gross income for the taxable year is $18,000. No reduction in the amount of the expenses is required under § 1.214A–3, and the taxpayer takes $4,800 ($400×12) of such expenses into account under section 214. The balance, or $7,200, he treats as medical expenses for purposes of section 213. The allowable deduction under section 213 for such expenses is limited to the excess of such balance of $7,200 over $540 (3 percent of the taxpayer's adjusted gross income of $18,000), or $6,600.

[T.D. 7411, 41 FR 15410, Apr. 13, 1976]

§ 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, 1/4 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 reimbursemet 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) 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]

§ 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 determing 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

	Component members			
	W	X	Y	Z
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]

§ 1.244–1 Deduction for dividends received on certain preferred stock.

A corporation is allowed a deduction under section 244 for dividends received on certain preferred stock of certain public utility corporations subject to taxation under chapter 1 of the Code. The deduction is allowable only for dividends received on the preferred stock of a public utility with respect to which the deduction for dividends paid provided in section 247 (relating to dividends paid on certain preferred

stock of public utilities) is allowable to the distributing corporation.

§ 1.244–2 Computation of deduction.

(a) *General rule.* Section 244(a) provides a formula for the computation of the deduction for dividends received on the preferred stock of a public utility. For purposes of this computation, the normal tax rate referred to in section 244(a)(2)(B) shall be determined without regard to any additional tax imposed by section 1562(b). See section 1562(b)(4). The deduction computed under section 244(a) is subject to the limitation provided in section 246.

(b) *Qualifying dividends.* Section 244(b) provides that in the case of dividends received on the preferred stock of a public utility in taxable years ending after December 31, 1963, which are ''qualifying dividends''(as defined in section 243(b)(1), but determined without regard to section 243(c)(4)), the computation of the deduction for dividends received shall be made by applying the formula provided by section 244(a) separately to such qualifying dividends. For such purposes, 100 percent shall be used in lieu of the 85 percent specified in section 244(a)(3).

(c) *Examples.* The computation of the deduction provided in section 244 may be illustrated by the following examples:

Example 1. Corporation X, which files its income tax returns on the calendar year basis, received in 1965 $100,000 as dividends on the preferred stock of corporation Y, a public utility corporation which is subject to taxation under chapter 1 of the Code. The deduction provided in section 247 is allowable to Y, the distributing corporation, with respect to these dividends and they are not ''qualifying dividends''(as defined in section 243(b)(1) but determined without regard to section 243(c)(4)). The corporation normal tax rate and the surtax rate for the calendar year 1965 are 22 percent and 26 percent, respectively. The deduction allowable to X under section 244(a) for the year 1965 with respect to these dividends is $60,208.33, computed as follows:

Dividends received on preferred stock of corporation Y	$100,000.00
Less: The fraction specified in section 244(a)(2): 14/48×$100,000	29,166.67
Amount subject to 85-percent deduction	70,833.33
Deduction—85 percent of $70,833.33	60,208.33

The result would be the same if X or Y(or both) were subject to the 6-percent additional tax imposed by section 1562(b) for 1965.

Example 2. Assume the same facts as in *Example 1* and also assume that in 1965 corporation X received $200,000 as dividends on the preferred stock of Corporation Z, a public utility corporation which is subject to taxation under chapter 1 of the Code. Assume further that such dividends are ''qualifying dividends'' (as defined in section 243(b)(1) but determined without regard to section 243(c)(4)). The deduction provided in section 247 is allowable to Z, the distributing corporation, with respect to these dividends. The deduction allowable to X under section 244 for the year 1965 is $201,875, computed as follows:

Deduction allowable under section 244(a) with respect to the dividend received from Y (see *Example 1*)	$60,208.33
Deduction allowable under section 244(b) with respect to the dividend received from Z: Qualifying dividends received on preferred stock of corporation Z	200,000.00
Less: The fraction specified in section 244(a)(2): 14/48×$200,000	58,333.33
Deduction	141,666.67
Deduction allowable under section 244 for 1965	201,875.00

[T.D. 6992, 34 FR 825, Jan. 18, 1969]

§ 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]

§ 1.246–1 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 passthrough 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 passthrough 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

Stock	Z's holdings	RFC	Subportfolio
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 1/10 shares of preferred stock issued on or after October 1, 1942, and having a par value of $100 per share. Only 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.* (1) Section 248(a) provides that a corporation may elect for any taxable year beginning after December 31, 1953, to treat its organizational expenditures, as defined in subsection (b) of section 248 and in paragraph (b) of this section, as deferred expenses. A corporation which exercises such election must, at the time it makes the election, select a period of not less than 60 months, beginning with the month in which it began business, over which it will amortize its organizational expenditures. The period selected by the corporation may be equal to or greater, but not less, than 60 months, but in any event it must begin with the month in which the corporation began business. The organizational expenditures of the corporation which are treated as deferred expenses under the provisions of section 248 and this section shall then be allowed as a deduction in computing taxable income ratably over the period selected by the taxpayer. The period selected by the taxpayer in making its election may not be subsequently changed but shall be adhered to in computing taxable income for the taxable year for which the election is made and all subsequent taxable years.

(2) If a corporation exercises the election provided in section 248(a), such election shall apply to all of its expenditures which are organizational expenditures within the meaning of subsection (b) of section 248 and paragraph (b) of this section. The election shall apply, however, only with respect to expenditures incurred before the end of the taxable year in which the corporation begins business (without regard to whether the corporation files its returns on the accrual or cash method of accounting or whether the expenditures are paid in the taxable year in which they are incurred), if such expenditures are paid or incurred on or after August 16, 1954 (the date of enactment of the Internal Revenue Code of 1954).

(3) 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.

(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.* The election provided by section 248(a) and paragraph (a) of this section shall be made in a statement attached to the taxpayer's return for the taxable year in which it begins business. Such taxable year must be one which begins after December 31, 1953. The return and statement must be filed not later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year in which the taxpayer begins business. The statement shall set forth the description and amount of the expenditures involved, the date such expenditures were incurred, the month in which the corporation began business, and the number of months (not less than 60 and beginning with the month in which the taxpayer began business) over which such expenditures are to be deducted ratably.

§ 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 subdivision (i) of this subparagraph, 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 rating or the credit rating of the obligation during such period (determined on the basis of widely published ratings of recognized credit rating services or on the basis of other relevant facts and circumstances which reflect the relative credit ratings 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 date*—(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).

(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]

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, § 1.162–2, and paragraph (d) of § 1.162–5 (relating to trade or business expenses), section 170 and paragraph (a)(2) of § 1.170–2 or paragraph (g) of § 1.170A–1 (relating to charitable contributions), section 212 and § 1.212–1 (relating to expenses for production of income), section 213(e) and paragraph (e) of § 1.213–1 (relating to medical expenses) or section 217(a) and paragraph (a) of § 1.217–1 (relating to moving expenses). The taxpayer's costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses. The costs of the taxpayer's lodging not incurred in traveling away from home are personal expenses and are not deductible unless they qualify as deductible expenses under section 217. Except as permitted under section 162, 212, or 217, the costs of the taxpayer's meals not incurred in traveling away from home are 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]

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(3) Stock issuance transactions [Reserved].
(4) Borrowings.
(5) Treatment of capitalized amounts by option writer.
(h) Application to accrual method taxpayers.
(i) [Reserved].
(j) Coordination with other provisions of the Internal Revenue Code.
(k) Treatment of indirect payments.
(l) Examples.
(m) Effective date.
(n) Accounting method changes.
(1) In general.
(2) Scope limitations.
(3) Section 481(a) adjustment.

[T.D. 9107, 69 FR 444, Jan. 5, 2004]

§ 1.263(a)–1 Capital expenditures; In general.

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for:

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. See section 162 and § 1.162–4. See section 263A and the regulations thereunder for cost capitalization rules which apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in § 1.263A–1T (a)(5)(iii)), including films, sound recordings, video tapes, books, or similar properties. An amount referred to in paragraph (a) of this section is a capital expenditure that is taken into account through inclusion in inventory costs or a charge to capital accounts or basis no earlier than the taxable year during which the amount is incurred within the meaning of § 1.446–1(c)(1)(ii). See section 263A and the regulations thereunder for cost capitalization rules that apply to amounts referred to in paragraph (a) of this section with respect to the production of real and tangible personal property (as defined in § 1.263A–2(a)(2)), including films, sound recordings, video tapes, books, or similar properties.

(c) The provisions of paragraph (a) (1) of this section shall not apply to expenditures deductible under:

(1) Section 616 and §§ 1.616–1 through 1.616–3, relating to the development of mines or deposits,

(2) Section 174 and §§ 1.174–1 through 1.174–4, relating to research and experimentation,

(3) Section 175 and §§ 1.175–1 through 1.175–6, relating to soil and water conservation,

(4) Section 179 and §§ 1.179–1 through 1.179–5, relating to election to expense certain depreciable business assets,

(5) Section 180 and §§ 1.180–1 and 1.180–2, relating to expenditures by farmers for fertilizer, lime, etc., and

(6) Section 182 and §§ 1.182–1 through 1.182–6, relating to expenditures by farmers for clearing land.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6794, 30 FR 792, Jan. 26, 1965; T.D. 8121, 52 FR 414, Jan. 6, 1987; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8408, 57 FR 12419, Apr. 10, 1992; T.D. 8482, 58 FR 42207, Aug. 9, 1993]

§ 1.263(a)–2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments. See section 263A and the regulations thereunder for capitalization rules which apply to amounts expended in securing and producing a copyright

and plates in connection with the production of property, including films, sound recordings, video tapes, books, or similar properties.

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts 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. Such amounts are capital investments and are not deductible. See section 118 and § 1.118–1.

(g) A holding company which guarantees 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 shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 8131, 52 FR 10084, Mar. 30, 1987]

§ 1.263(a)–3 Election to deduct or capitalize certain expenditures.

(a) Under certain provisions of the Code, taxpayers may elect to treat capital expenditures as deductible expenses or as deferred expenses, or to treat deductible expenses as capital expenditures.

(b) 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).

(4) Section 177 (trademark and trade name expenditures).

(5) Section 179 (election to expense certain depreciable business assets).

(6) Section 180 (expenditures by farmers for fertilizer, lime, etc.).

(7) Section 182 (expenditures by farmers for clearing land).

(8) Section 248 (organizational expenditures of a corporation).

(9) Section 266 (carrying charges).

(10) Section 615 (exploration expenditures).

(11) Section 616 (development expenditures).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6794, 30 FR 792, Jan. 26, 1965; T.D. 8121, 52 FR 414, Jan. 6, 1987]

§ 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, non-cancelable 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(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:

§ 1.263A–1 Uniform Capitalization of Costs.

(a) Introduction.
(1) In general.
(2) Effective dates.
(3) General scope.
(i) Property to which section 263A applies.
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(iv) Inventories valued at market.
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(ii) New taxpayers.
(iii) Method changes.
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(B) Direct labor costs.
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(i) In general.
(ii) Examples of indirect costs required to be capitalized.
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(H) Storage costs.
(I) Cost recovery.
(J) Depletion.
(K) Rent.
(L) Taxes.
(M) Insurance.
(N) Utilities.
(O) Repairs and maintenance.
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(R) Tools and equipment.
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(B) Non-inventory property held for sale.
(C) Certain self-constructed assets.
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(ii) Election to exclude self-constructed assets.
(3) General allocation formula.
(4) Labor-based allocation ratio.
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(i) In general.
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(2) Optional capitalization of period costs.
(i) In general.
(ii) Period costs eligible for capitalization.
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§ 1.263A–2 Rules Relating to Property Produced by the Taxpayer.

(a) In general.
(1) Produce.
(i) In general.
(ii) Ownership.
(A) General rule.
(B) Property produced for the taxpayer under a contract.
(*1*) In general.
(*2*) Definition of contract.
(C) Home construction contracts.
(2) Tangible personal property.
(i) General rule.
(ii) Intellectual or creative property.
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(*1*) Books.
(*2*) Sound recordings.
(B) Intellectual or creative property that is not tangible personal property.
(*1*) Evidences of value.
(*2*) Property provided incident to services.
(3) Costs required to be capitalized by producers.
(i) In general.
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(4) Practical capacity concept.
(5) Taxpayers required to capitalize costs under this section.
(b) Simplified production method.
(1) Introduction.
(2) Eligible property.
(i) In general.
(A) Inventory property.
(B) Non-inventory property held for sale.
(C) Certain self-constructed assets.
(D) Self-constructed assets produced on a repetitive basis.
(ii) Election to exclude self-constructed assets.
(3) Simplified production method without historic absorption ratio election.
(i) General allocation formula.
(ii) Definitions.
(A) Absorption ratio.
(*1*) Additional section 263A costs incurred during the taxable year.
(*2*) Section 471 costs incurred during the taxable year.
(B) Section 471 costs remaining on hand at year end.
(iii) LIFO taxpayers electing the simplified production method.
(A) In general.
(B) LIFO increment.
(C) LIFO decrement.
(iv) De minimis rule for producers with total indirect costs of $200,000 or less.
(A) In general.
(B) Related party and aggregation rules.
(v) Examples.
(4) Simplified production method with historic absorption ratio election.
(i) In general.
(ii) Operating rules and definitions.
(A) Historic absorption ratio.
(B) Test period.
(*1*) In general.
(*2*) Updated test period.
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(*1*) In general.
(*2*) Extension of qualifying period.
(iii) Method of accounting.
(A) Adoption and use.
(B) Revocation of election.
(iv) Reporting and recordkeeping requirements.
(A) Reporting.
(B) Recordkeeping.

(v) Transition rules.
(vi) Example.
(c) Additional simplified methods for producers.
(d) Cross reference.

§ 1.263A–3 Rules Relating to Property Acquired for Resale

(a) Capitalization rules for property acquired for resale.
(1) In general.
(2) Resellers with production activities.
(i) In general.
(ii) Exception for small resellers.
(iii) De minimis production activities.
(A) In general.
(B) Example.
(3) Resellers with property produced under a contract.
(4) Use of the simplified resale method.
(i) In general.
(ii) Resellers with de minimis production activities.
(iii) Resellers with property produced under a contract.
(iv) Application of simplified resale method.
(b) Gross receipts exception for small resellers.
(1) In general.
(i) Test period for new taxpayers.
(ii) Treatment of short taxable year.
(2) Definition of gross receipts.
(i) In general.
(ii) Amounts excluded.
(3) Aggregation of gross receipts.
(i) In general.
(ii) Single employer defined.
(iii) Gross receipts of a single employer.
(iv) Examples.
(c) Purchasing, handling, and storage costs.
(1) In general.
(2) Costs attributable to purchasing, handling, and storage.
(3) Purchasing costs.
(i) In general.
(ii) Determination of whether personnel are engaged in purchasing activities.
(A) ⅓–⅔ rule for allocating labor costs.
(B) Example.
(4) Handling costs.
(i) In general.
(ii) Processing costs.
(iii) Assembling costs.
(iv) Repackaging costs.
(v) Transportation costs.
(vi) Costs not considered handling costs.
(A) Distribution costs.
(B) Delivery of custom-ordered items.
(C) Repackaging after sale occurs.
(5) Storage costs.
(i) In general.
(ii) Definitions.
(A) On-site storage facility.
(B) Retail sales facility.
(C) An integral part of a retail sales facility.
(D) On-site sales.
(E) Retail customer.
(*1*) In general.
(*2*) Certain non-retail customers treated as retail customers.
(F) Off-site storage facility.
(G) Dual-function storage facility.
(iii) Treatment of storage costs incurred at a dual-function storage facility.
(A) In general.
(B) Dual-function storage facility allocation ratio.
(*1*) In general.
(*2*) Illustration of ratio allocation.
(*3*) Appropriate adjustments for other uses of a dual-function storage facility.
(C) De minimis 90–10 rule for dual-function storage facilities.
(iv) Costs not attributable to an off-site storage facility.
(v) Examples.
(d) Simplified resale method.
(1) Introduction.
(2) Eligible property.
(3) Simplified resale method without historic absorption ratio election.
(i) General allocation formula.
(A) In general.
(B) Effect of allocation.
(C) Definitions.
(*1*) Combined absorption ratio.
(*2*) Section 471 costs remaining on hand at year end.
(D) Storage and handling costs absorption ratio.
(E) Purchasing costs absorption ratio.
(F) Allocable mixed service costs.
(ii) LIFO taxpayers electing simplified resale method.
(A) In general.
(B) LIFO increment.
(C) LIFO decrement.
(iii) Permissible variations of the simplified resale method.
(iv) Examples.
(4) Simplified resale method with historic absorption ratio election.
(i) In general.
(ii) Operating rules and definitions.
(A) Historic absorption ratio.
(B) Test period.
(*1*) In general.
(*2*) Updated test period.
(C) Qualifying period.
(*1*) In general.
(*2*) Extension of qualifying period.
(iii) Method of accounting.
(A) Adoption and use.
(B) Revocation of election.
(iv) Reporting and recordkeeping requirements.
(A) Reporting.
(B) Recordkeeping.
(v) Transition rules.
(vi) Example.

(5) Additional simplified methods for resellers.
(e) Cross reference.

§ 1.263A–4 Rules for property produced in a farming business.

(a) Introduction.
(1) In general.
(2) Exception.
(i) In general.
(ii) Tax shelter.
(A) In general.
(B) Presumption.
(iii) Examples.
(3) Costs required to be capitalized or inventoried under another provision.
(4) Farming business.
(i) In general.
(A) Plant.
(B) Animal.
(ii) Incidental activities.
(A) In general.
(B) Activities that are not incidental.
(iii) Examples.
(b) Application of section 263A to property produced in a farming business.
(1) In general.
(i) Plants.
(ii) Animals.
(2) Preproductive period.
(i) Plant.
(A) In general.
(B) Applicability of section 263A.
(C) Actual preproductive period.
(*1*) Beginning of the preproductive period.
(*2*) End of the preproductive period.
(*i*) In general.
(*ii*) Marketable quantities.
(D) Examples.
(ii) Animal.
(A) Beginning of the preproductive period.
(B) End of the preproductive period.
(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.
(d) Election not to have section 263A apply.
(1) Introduction.
(2) Availability of the election.
(3) Time and manner of making the election.
(i) Automatic election.
(ii) Nonautomatic election.
(4) Special rules.
(i) Section 1245 treatment.
(ii) Required use of alternative depreciation system.
(iii) Related person.
(A) In general.
(B) Members of family.
(5) Examples.
(e) Exception for certain costs resulting from casualty losses.
(1) In general.
(2) Ownership.
(3) Examples.
(4) Special rule for citrus and almond groves.
(i) In general.
(ii) Example.
(f) Effective date and change in method of accounting.
(1) Effective date.
(2) Change in method of accounting.

§ 1.263A–7 Changing a method of accounting under section 263A.

(a) Introduction.
(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) Effective date.
(5) Definition of change in method of accounting.
(b) Rules applicable to a change in method of accounting.
(1) General rules.
(2) Special rules.
(i) Ordering rules when multiple changes in method of accounting occur in the year of change.
(A) In general.
(B) Exceptions to the general ordering rule.
(*1*) Change from the LIFO inventory method.
(*2*) Change from the specific goods LIFO inventory method.
(*3*) Change in overall method of accounting.
(*4*) Change in method of accounting for depreciation.
(ii) Adjustment required by section 481(a).
(iii) Base year.
(A) Need for a new base year.
(*1*) Facts and circumstances revaluation method used.
(*2*) 3-year average method used.
(*i*) Simplified method not used.
(*ii*) Simplified method used.
(B) Computing a new base year.
(c) Inventory.
(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.
(C) Weighted average method for specific goods LIFO taxpayers.
(*1*) In general.
(*2*) Example.
(D) Adjustments to inventory costs from prior years.
(v) 3-year average method.
(A) In general.
(B) Consecutive year requirement.
(C) Example.
(D) Short taxable years.
(E) Adjustments to inventory costs from prior years.
(*1*) General rule.
(*2*) Examples of costs eligible for restatement adjustment procedure.
(F) Restatement adjustment procedure.
(*1*) In general.
(*2*) Examples of restatement adjustment procedure.
(3) Intercompany items.
(i) Revaluing intercompany transactions.
(ii) Example.
(iii) Availability of revaluation methods.
(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.
(2) Revaluing property.

§ 1.263A–8 Requirement to capitalize interest.

(a) In general.
(1) General rule.
(2) Treatment of interest required to be capitalized.
(3) Methods of accounting under section 263A(f).
(4) Special definitions.
(i) Related person.
(ii) Placed in service.
(b) Designated property.
(1) In general.
(2) Special rules.
(i) Application of thresholds.
(ii) Relevant activities and costs.
(iii) Production period and cost of production.
(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.
(d) Production.
(1) Definition of produce.
(2) Property produced under a contract.
(i) Customer.
(ii) Contractor.
(iii) Definition of a contract.
(iv) Determination of whether thresholds are satisfied.
(A) Customer.
(B) Contractor.
(v) Exclusion for property subject to long-term contract rules.
(3) Improvements to existing property.
(i) In general.
(ii) Real property.
(iii) Tangible personal property.

§ 1.263A–9 The avoided cost method.

(a) In general.
(1) Description.
(2) Overview.
(i) In general.
(ii) Rules that apply in determining amounts.
(3) Definitions of interest and incurred.
(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.
(1) General rule.
(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.
(A) General rule.
(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.
(i) Allocation of total incurred interest to units.
(ii) Application of related person rules to average excess expenditures.
(iii) Special rule for corporations.
(d) Election not to trace debt.
(1) General rule.
(2) Example.
(e) Election to use external rate.
(1) In general.
(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.
(iii) Production period beginning or ending during the computation period.
(2) Measurement dates.
(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.
(5) Treatment of intercompany transactions.
(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.
(v) Benefitted property placed in service before production completed on common feature.
(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.
(h) Installation.

§ 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.
(ii) Subsequent units.
(3) Beginning of production period.
(i) First productive well unit.
(ii) Subsequent wells.
(4) End of production period.
(5) Accumulated production expenditures.
(i) First productive well unit.
(ii) Subsequent well unit.
(6) Allocation of interest capitalized with respect to first productive well unit.
(7) Examples.

§ 1.263A–14 Rules for related persons.

§ 1.263A–15 Effective dates, transitional rules, and anti-abuse rule.

(a) Effective dates.
(b) Transitional rule for accumulated production expenditures.
(1) In general.
(2) Property used to produce designated property.
(c) Anti-abuse rule.

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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) *Effective 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 effective for taxable years beginning after December 31, 1993. 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 resellers.* See section 263A(b)(2)(B) for the $10,000,000 gross receipts exception for small resellers of personal property. See §1.263A–3(b) for rules relating to this exception. See also the exception for small resellers with de minimis production activities in §1.263A–3(a)(2)(ii) and the exception for small resellers that have property produced under contract in §1.263A–3(a)(3).

(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 and the simplified resale method in §§1.263A–2(b) 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 the use, sale, or disposition of property.

(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) and (iii) of this section, for purposes of the regulations under section 263A, a taxpayer's section 471 costs are the costs, other than interest, capitalized under its method of accounting immediately prior to the effective date of section 263A. Thus, although section 471 applies only to inventories, section 471 costs include any non-inventory costs, other than interest, capitalized or included in acquisition or production costs under the taxpayer's method of accounting immediately prior to the effective date of section 263A.

(ii) *New taxpayers.* In the case of a new taxpayer, section 471 costs are those acquisition or production costs, other than interest, that would have

been required to be capitalized by the taxpayer if the taxpayer had been in existence immediately prior to the effective date of section 263A.

(iii) *Method changes.* If a taxpayer included a cost described in § 1.471–11(c)(2)(iii) in its inventoriable costs immediately prior to the effective date of section 263A, that cost is included in the taxpayer's section 471 costs under paragraph (d)(2)(i) of this section. Except as provided in the following sentence, a change in the financial reporting practices of a taxpayer for costs described in § 1.471–11(c)(2)(iii) subsequent to the effective date of section 263A does not affect the classification of these costs as section 471 costs. A taxpayer may change its established methods of accounting used in determining section 471 costs only with the consent of the Commissioner as required under section 446(e) and the regulations thereunder.

(3) *Additional section 263A costs.* Additional section 263A costs are defined as the costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately prior to the effective date of section 263A (adjusted as appropriate for any changes in methods of accounting for section 471 costs under paragraph (d)(2)(iii) of this section), but that are required to be capitalized under section 263A. For new taxpayers, additional section 263A costs are defined as the costs, other than interest, that the taxpayer must capitalize under section 263A, but which the taxpayer would not have been required to capitalize if the taxpayer had been in existence prior to the effective date of section 263A.

(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).

(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* include the costs 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.

(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.* 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 be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable

allocation of indirect costs between production, resale, and other activities.

(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 or groups of units of property. Thus, for example, a cost described in §1.162–3, relating to the cost of a material or supply, is an indirect material 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.* 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 (e.g., amortization) of the initial fees

incurred to obtain the license or franchise and any minimum annual payments and royalties that are incurred by a licensee or a franchisee.

(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 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 reports. 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 reports. 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 assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(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 X ($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 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) *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.

[T.D. 8482, 58 FR 42209, Aug. 9, 1993, as amended by T.D. 8559, 59 FR 39961, Aug. 5, 1994; T.D. 8584, 59 FR 67197, Dec. 29, 1994; T.D. 8597, 60 FR 36680, July 18, 1995; T.D. 8728, 62 FR 42054, Aug. 5, 1997; T.D. 8729, 62 FR 44546, Aug. 22, 1997; T.D. 8897, 65 FR 50644, Aug. 21, 2000; 65 FR 61092, Oct. 16, 2000]

§ 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.

(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 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and the taxpayer's average annual gross receipts for the three preceding taxable years do not exceed $10,000,000. 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 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 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 assets produced on a repetitive basis.* Self-constructed assets produced by the taxpayer on a routine and repetitive basis in the ordinary course of the taxpayer's trade or business.

(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.

(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.

(*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) *Transition rules.* 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.

(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) *Additional simplified methods for producers.* The Commissioner may prescribe additional elective simplified methods by revenue ruling or revenue procedure.

(d) *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.

[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]

§ 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, section 263A does not apply to personal property described in section 1221(1) acquired for resale by a reseller whose average annual gross receipts for the three previous taxable years do not exceed $10,000,000 (small reseller). 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) *Exception for small resellers.* Under this paragraph (a)(2)(ii), a small reseller is not required to capitalize additional section 263A costs associated with any personal property that is produced incident to its resale activities, provided the production activities are de minimis (within the meaning of paragraph (a)(2)(iii) of this section).

(iii) *De minimis production activities*—(A) *In general.* (*1*) 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—

(*i*) 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

(*ii*) The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(*2*) For purposes of this de minimis presumption, gross receipts has the same definition as provided in paragraph (b) of this section except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

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

Example—Small reseller with de minimis production activities. Taxpayer N is a small reseller in the retail grocery business whose average annual gross receipts for the three previous taxable years are less than $10,000,000. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N's gross receipts from its bakeries are 5% of the entire grocery business. N's labor costs from its bakeries are 3% of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10%, N's production activities are de minimis. Further, because N's production activities are incident to its resale activities, N is not required to capitalize any additional section 263A costs associated with its produced property.

(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 reseller 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 reseller 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)) 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)(2)(iii) 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.

(b) *Gross receipts exception for small resellers*—(1) *In general.* Section 263A does not apply to any personal property acquired for resale during any taxable year if the taxpayer's (or its predecessors') average annual gross receipts for the three previous taxable years (test period) do not exceed $10,000,000. However, taxpayers that acquire real property for resale are subject to section 263A with respect to real property regardless of their gross receipts. See section 263A(b)(2)(B).

(i) *Test period for new taxpayers.* For purposes of applying this exception, 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.

(ii) *Treatment of short taxable year.* In the case of a short taxable year, the taxpayer's gross receipts are annualized by—

(A) Multiplying the gross receipts of the short taxable year by 12; and

(B) Dividing the product determined in paragraph (b)(1)(ii)(A) of this section by the number of months in the short taxable year.

(2) *Definition of gross receipts*—(i) *In general.* Gross receipts are the total amount, as determined under the taxpayer's method of accounting, derived from all of the taxpayer's trades or businesses (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold).

(ii) *Amounts excluded.* For purposes of this paragraph (b), gross receipts do not include amounts representing—

(A) Returns or allowances;

(B) Interest, dividends, rents, royalties, or annuities, not derived in the ordinary course of a trade or business;

(C) Receipts from the sale or exchange of capital assets, as defined in section 1221;

(D) Repayments of loans or similar instruments (e.g., a repayment of the principal amount of a loan held by a commercial lender);

(E) Receipts from a sale or exchange not in the ordinary course of business, such as the sale of an entire trade or business or the sale of property used in a trade or business as defined under section 1221(2); and

(F) Receipts from any activity other than a trade or business or an activity engaged in for profit.

(3) *Aggregation of gross receipts*—(i) *In general.* In determining gross receipts, all persons treated as a single employer under section 52(a) or (b), section 414(m), or any regulation prescribed under section 414 (or persons that would be treated as a single employer under any of these provisions if they had employees) shall be treated as one taxpayer. The gross receipts of a single employer (or the group) are determined by aggregating the gross receipts of all persons (or the members) of the group, excluding any gross receipts attributable to transactions occurring between group members.

(ii) *Single employer defined.* A controlled group, which is treated as a single employer under section 52(a), includes members of a controlled group within the meaning of section 1563(a), regardless of whether such members would be treated as component members of such group under section 1563(b). (See § 1.52–1(c).) Thus, for example, the gross receipts of a franchised corporation that is treated as an excluded member for purposes of section 1563(b) are included in the single employer's gross receipts under this aggregation rule, if such corporation and the taxpayer were members of the same controlled group under section 1563(a).

(iii) *Gross receipts of a single employer.* The gross receipts of a single employer

for the test period include the gross receipts of all group members (or their predecessors) that are members of the group as of the first day of the taxable year in issue, regardless of whether such persons were members of the group for any of the three preceding taxable years. The gross receipts of the single employer for the test period do not, however, include the gross receipts of any member that was a group member (including any predecessor) for any or all of the three preceding taxable years, and is no longer a group member as of the first day of the taxable year in issue. Any group member that has a taxable year of less than 12 months must annualize its gross receipts in accordance with paragraph (b)(1)(ii) of this section.

(iv) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. Subsidiary acquired during the taxable year. A parent corporation, (P), has owned 100% of the stock of another corporation, (S1), continually since 1989. P and S1 are calendar year taxpayers. S1 acquires property for resale. On January 1, 1994, P acquires 100% of the stock of another calendar year corporation (S2). In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, the gross receipts of P, S1, and S2 for 1991, 1992, and 1993 are aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the three corporations.

Example 2. Subsidiary sold during the taxable year. Since 1989, a parent corporation, (P), has continually owned 100% of the stock of two other corporations, (S1) and (S2). The three corporations are calendar year taxpayers. S1 acquires property for resale. On December 31, 1993, P sells all of its stock in S2. In determining whether S1's resale activities are subject to the provisions of section 263A for 1994, only the gross receipts of P and S1 for 1991, 1992, and 1993 must be aggregated, excluding the gross receipts, if any, attributable to transactions occurring between the two corporations.

(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 on-site 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 on-site 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.

(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.

(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.

(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:

$$\frac{\text{Storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{(\$110{,}000 + \$80{,}000) + (\$90{,}000 + \$80{,}000)}{\$2{,}000{,}000 + \$10{,}000{,}000} = \frac{\$190{,}000 + \$170{,}000}{\$12{,}000{,}000} = \frac{\$360{,}000}{\$12{,}000{,}000} = 3.0\%$$

(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
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) *Transition rules.* 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.

(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.

[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]

§ 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)(4) 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) 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 464(c); 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) *Costs required to be capitalized or inventoried under another provision.* The exceptions from capitalization provided in paragraphs (a)(2), (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.

(4) *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)(4):

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, Individual A will not be required to capitalize costs with respect to its resale activities under section 263A.

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*—(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. The election is a method of accounting under section 446, and once an election is made, it 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. In the case of a partnership or S corporation, the election must be made by the partner, shareholder, or member.

(ii) *Nonautomatic election.* A taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) 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) *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).

(f) *Effective date and change in method of accounting*—(1) *Effective date.* 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) *Change in method of accounting.* 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 the regulations thereunder apply. For property that is not inventory in the hands of the taxpayer, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of this section for costs incurred after August 21, 2000, provided

the change is made for the first taxable year ending after August 21, 2000. For inventory property, a taxpayer is granted the consent of the Commissioner to change its method of accounting to comply with the provisions of this section for the first taxable year beginning after August 21, 2000. A taxpayer changing its method of accounting under this paragraph (f)(2) must file a Form 3115, ''Application for Change in Accounting Method,'' in accordance with the automatic consent procedures in Rev. Proc. 99–49 (1999–2 I.R.B. 725) (see § 601.601(d)(2) of this chapter). However, the scope limitations in section 4.02 of Rev. Proc. 99–49 do not apply, provided the taxpayer's method of accounting for property produced in a farming business is not an issue under consideration within the meaning of section 3.09 of Rev. Proc. 99–49. If the taxpayer is under examination, before an appeals office, or before a federal court at the time that a copy of the Form 3115 is filed with the national office, the taxpayer must provide a duplicate copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the time the copy of the Form 3115 is filed. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate. Further, in the case of property that is not inventory in the hands of the taxpayer, a change under this paragraph (f)(2) is made on a cutoff basis as described in section 2.06 of Rev. Proc. 99–49 and without the audit protection provided in section 7 of Rev. Proc. 99–49. However, a taxpayer may receive such audit protection for non-inventory property by taking into account any section 481(a) adjustment that results from the change in method of accounting to comply with this section. A taxpayer that opts to determine a section 481(a) adjustment (and, thus, obtain audit protection) for non-inventory property must take into account only additional section 263A costs incurred after December 31, 1986, in taxable years ending after December 31, 1986. Any change in method of accounting that is not made for the taxpayer's first taxable year ending or beginning after August 21, 2000, whichever is applicable, must be made in accord with the procedures in Rev. Proc. 97–27 (1997–1 C.B. 680) (see § 601.601(d)(2) of this chapter).

[T.D. 8897, 65 FR 50644, Aug. 21, 2000; 65 FR 61092, Oct. 16, 2000]

§ 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) Resellers of personal property whose average annual gross receipts for

the immediately preceding 3-year period (or lesser period if the taxpayer was not in existence for the three preceding taxable years) exceed $10,000,000 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) *Effective date.* 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.

(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 Rev. Proc. 97–27 (1997–21 I.R.B. 10) 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 Rev. Proc. 2002–9 (2002–1 C.B. 327) and Rev. Proc. 97–27 (1997–1 C.B. 680) (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 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.

(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

LIFO product and layer	Number	Cost	Carrying values
			$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.

[T.D. 8728, 62 FR 42054, Aug. 5, 1997, as amended by T.D. 9131, 69 FR 33572, June 16, 2004]

§ 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.

(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.

[T.D. 8584, 59 FR 67198, Dec. 29, 1994; 60 FR 16574, Mar. 31, 1995]

§ 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 lookback 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.

(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 interest paid to a tax-exempt related person), 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), exempt related person interest under section 163(j), nor passive interest under section 469 before capitalizing any interest that is either investment interest, exempt related person interest, 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 [(1.1×1.1)−1]. The interest factor applied to the 3-year old inventory is .331 [(1.1×1.1×1.1)−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.

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§ 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.

(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]

§ 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]

§ 1.267(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 2 1/2 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 payeee 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 2 1/2 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 2 1/2 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 2 1/2 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) or (a)(3) 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) *Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company*—(i) *Foreign personal holding companies.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552,

then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) *Controlled foreign corporations.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) *Passive foreign investment companies.* If an amount to which paragraph (b) of this section otherwise applies is owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(iv) *Examples.* The rules of this paragraph (c)(4) may be illustrated by the following examples. Application of the provisions of sections 951 through 964 are provided for illustration only, and do not provide substantive rules concerning the operation of those provisions. The principles of these examples apply equally to the provisions of paragraphs (c)(4) (i) through (iii) of this section.

Example 1. P, a domestic corporation, owns 100 percent of the total combined voting power and value of the stock of both FC1 and FC2. P is a calendar year taxpayer that uses the accrual method of accounting in computing its income and deductions. FC1 is incorporated in Country X, and FC2 is incorporated in Country Y. FC1 and FC2 are controlled foreign corporations within the meaning of section 957, and are both calendar year taxpayers. FC1 computes its taxable income and earnings and profits, for purposes of sections 951 through 964, using the accrual method of accounting, while FC2 uses the cash method. In Year 1 FC1 has gross income of $10,000 that is described in section 952 (a) (''subpart F income''), and which includes interest owed to FC1 by P that is described in paragraph (b) of this section and that is otherwise allowable as a deduction to P under chapter 1. The interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 2. The facts are the same as in *Example 1,* except that in Year 1 FC1 reports no subpart F income because of the application of section 954 (b)(3)(A) (the subpart F de minimis rule). Because the amount owed to FC1 by P is includible in FC1's gross income in Year 1, the interest owed to FC1 is allowable as a deduction to P in Year 1.

Example 3. The facts are the same as in *Example 1.* In Year 1, FC1 accrues interest owed to FC2 that would be allowable as a deduction by FC1 under chapter 1 if FC1 were a domestic corporation. The interest owed to FC2 by FC1 is paid by FC1 in Year 2. Because FC2 uses the cash method of accounting in computing its taxable income for purposes of subpart F, the interest owed by FC1 is allowable as a deduction by FC1 in Year 2, and not in Year 1.

(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). 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).

[T.D. 8465, 58 FR 237, Jan. 5, 1993]

§ 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 2 1/2 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 2 1/2 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 (e.g., a donee) 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.

§ 1.267(d)–2 Effective date; taxable years subject to the Internal Revenue Code of 1939.

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.

§ 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 because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. See § 1.1502–13(c)(6)(ii).

(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.

(k) *Cross-reference.* For additional rules applicable to the disposition or deconsolidation of the stock of members of consolidated groups, see §§1.337(d)–2T, 1.1502–13(f)(6), and 1.1502–35T.

(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) *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]

EFFECTIVE DATE NOTE: By T.D. 9187, 70 FR 10326, Mar. 3, 2005, §1.267(f)–1(k) was amended by removing ''§1.337(d)–2T'' and adding '' §1.337(d)–2'', effective Apr. 4, 2005.

§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]

§ 1.270–1 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.

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 and 1015, and the regulations thereunder.

§ 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 expenses—(a) Introductory.* In the case of any expenditure for entertainment paid or incurred by one person in connection with the performance by him of services for another person (whether or not such other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on allowability of deductions provided for in paragraphs (a) through (e) of this section shall be applied only once, either (*1*) to the person who makes the expenditure or (*2*) to the person who actually bears the expense, but not to both. For purposes of this subdivision (iv), the term *reimbursement or other expense allowance arrangement* has the same meaning as it has in section 62(2)(A), but without regard to whether the taxpayer is the employee of a person for whom services are performed. If an expenditure of a type described in this subdivision properly constitutes a dividend paid to a shareholder, unreasonable compensation paid to an employee, or a personal, living or family expense, nothing in this exception prevents disallowance of the expenditure to the taxpayer under other provisions of the Code.

(*b*) *Reimbursement arrangements between employee and employer.* In the case of an expenditure for entertainment paid or incurred by an employee under a reimbursement or other expense allowance arrangement with his employer, the limitations on deductions provided for in paragraphs (a) through (e) of this section shall not apply:

(*1*) *Employees.* To the employee except to the extent his employer has treated the expenditure on the employer's income tax return as originally filed as compensation paid to the employee and as wages to such employee for purposes of withholding under Chapter 24 (relating to collection of income tax at source on wages).

(*2*) *Employers.* To the employer to the extent he has treated the expenditure as compensation and wages paid to an employee in the manner provided in (*b*)(*1*) of this subdivision.

(*c*) *Reimbursement arrangements between independent contractors and clients or customers.* In the case of an expenditure for entertainment paid or incurred by one person (hereinafter termed ''independent contractor'') under a reimbursement or other expense allowance arrangement with another person other than an employer (hereinafter termed ''client or customer''), the limitations on deductions provided for in

paragraphs (a) through (e) of this section shall not apply:

(*1*) *Independent contractors.* To the independent contractor to the extent he accounts to his client or customer within the meaning of section 274(d) and the regulations thereunder. See § 1.274–5.

(*2*) *Clients or customers.* To the client or customer if the expenditure is disallowed to the independent contractor under paragraphs (a) through (e) of this section.

(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]

§ 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)–(l) [Reserved]. For further guidance, see § 1.274–5T(k) and (l).

(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.

[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]

§ 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 corrobative 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) *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 (i.e., 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 and fire 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, and

(S) Such other vehicles as the Commissioner may designate.

(3) *Clearly marked police or fire vehicles.* A police or fire 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 or fire fighter 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 obligation to respond to an emergency is prohibited by such governmental unit. A police or fire vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police or fire 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 (i.e., 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 on 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 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).

(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 §1.61–21(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.* 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]

§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 §1.61–2T(f) (5) and (6)) required to use an automobile (as defined in §1.61–2T(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 §1.61–2T(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 §1.61–2T(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 §1.61–2T(f) (5) and (6) required to use an automobile (as defined in §1.61–2T(d)(1)(ii)), and

(F) The employee includes in gross income the commuting value determined by the employer as provided in §1.61–2T(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 §1.132–5T(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* § 1.132–5T(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 § 1.61–2T(d)(1)(ii).

(4) *Vehicle.* The term *vehicle* has the same meaning as prescribed in § 1.61–2T(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]

§ 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 date.

Except as provided in § 1.274–2 (a) and (e), §§ 1.274–1 through 1.274–7 apply with respect to taxable years ending after December 31, 1962, but only in respect of periods after such date.

[T.D. 8051, 50 FR 36576, Sept. 9, 1985]

§ 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 1 1/2 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).

(h) *Statement to be attached to return.* In any case where any corporation claims a deduction in excess of $5 million for interest paid or incurred during the taxable year on obligations issued to provide consideration for acquisitions described in section 279(b)(1)

of stock in, or assets of, an acquired corporation, the corporation shall attach to its return for such taxable year a statement which includes the particular provisions of section 279 and, in sufficient detail, the facts establishing that such obligations were not corporate acquisition indebtedness, or that the amount of the deduction for interest on its corporate acquisition indebtedness did not exceed the amount of interest which may be deducted on such obligations under section 279(a).

[T.D. 7262, 38 FR 5847, Mar. 7, 1973]

§ 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 shall be 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 shall be eliminated, and

(2) In determining the earnings and profits of any member of an affiliated group, there shall be eliminated any amount of interest income received or accrued, and of interest expense paid or incurred, which is attributable to intercompany indebtedness,

(3) No gain or loss shall be recognized in any transaction between members of the affiliated group, and

(4) Members of an affiliated group who file a consolidated return shall not apply the provisions of § 1.1502–18 dealing with inventory adjustments in determining earnings and profits for purposes of this section.

(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]

§ 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.* The election under section 280C(c)(3) to have the provisions of section 280C(c) (1) and (2) not apply shall be made by claiming the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B) on an original return for the taxable year, filed at any time on or before the due date (including extensions) for filing the income tax return for such year. An election, once made for any taxable year, shall be irrevocable for that taxable year.

(b) *Transition rule*—(1) *In general.* In the case of a taxable year beginning after December 31, 1988, for which the due date (including extensions) for filing the return is on or before March 4, 1990, the election under section 280C(c)(3) shall be made by claiming the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B) on an original or amended return for such taxable year filed on or before March 3, 1990.

(2) *Taxpayers who made an election under former section 41(h).* If a taxpayer—

(i) Prior to December 19, 1989, made an election for a taxable year described in paragraph (b)(1) of this section under section 41(h) (as it existed before it was repealed by section 7814(e) of the Revenue Reconciliation Act of 1989) by not claiming any credit allowable under section 41(a), and

(ii) Has not filed an amended return on or before March 3, 1990 claiming the full credit allowable under section 41(a), the taxpayer will be treated as having made an election under section 280C(c)(3). Therefore, the provisions of section 280C(c) (1) and (2) shall not apply in such taxable year. However, in order to obtain the benefit of the reduced credit under section 41(a) determined by the method provided in section 280C(c)(3)(B), such a taxpayer must claim the reduced credit on an amended return filed before the expiration of the period prescribed in section 6511 for filing a claim for credit or refund of the tax imposed by chapter 1 of the Code.

(c) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1988.

[T.D. 8282, 55 FR 2376, Jan. 24, 1990; 55 FR 4049, Feb. 6, 1990]

§ 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)	(b)	(d)(2)	(c)	(d)(3)
(d)(1)	(d)(1)			(d)(4)
(d)(8)				(d)(5)
(d)(10)				(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

DOLLAR AMOUNTS: YEARS 1–3—Continued

Fair market value		Taxable year quarter			
Greater than—	But not greater than—	4th	3d	2d	1st
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
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 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 §1.274–5T(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 aggregate 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]

§ 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
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

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	
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]

§ 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:

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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 payments*, 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××$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).

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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
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]**