

## Internal Revenue Service, Treasury

## § 1.441-0

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### DEFERRED COMPENSATION, ETC. (CONTINUED)

### ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

#### ACCOUNTING PERIODS

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### § 1.441-4 Effective date

[T.D. 8996, 67 FR 35012, May 17, 2002]

### § 1.441-1 Period for computation of taxable income.

(a) *Computation of taxable income*—(1) *In general.* Taxable income must be computed and a return must be made for a period known as the taxable year. For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Internal Revenue Code, and the regulations thereunder.

(2) *Length of taxable year.* Except as otherwise provided in the Internal Revenue Code and the regulations thereunder (e.g., § 1.441-2 regarding 52-53-week taxable years), a taxable year may not cover a period of more than 12 calendar months.

(b) *General rules and definitions.* The general rules and definitions in this paragraph (b) apply for purposes of sections 441 and 442 and the regulations thereunder.

(1) *Taxable year.* *Taxable year* means—

(i) The period for which a return is made, if a return is made for a period of less than 12 months (short period). See section 443 and the regulations thereunder;

(ii) Except as provided in paragraph (b)(1)(i) of this section, the taxpayer's

required taxable year (as defined in paragraph (b)(2) of this section), if applicable;

(iii) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the taxpayer's annual accounting period (as defined in paragraph (b)(3) of this section), if it is a calendar year or a fiscal year; or

(iv) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the calendar year, if the taxpayer keeps no books, does not have an annual accounting period, or has an annual accounting period that does not qualify as a fiscal year.

(2) *Required taxable year*—(i) *In general.* Certain taxpayers must use the particular taxable year that is required under the Internal Revenue Code and the regulations thereunder (the required taxable year). For example, the required taxable year is—

(A) In the case of a foreign sales corporation or domestic international sales corporation, the taxable year determined under section 441(h) and § 1.921-1T(a)(11), (b)(4), and (b)(6);

(B) In the case of a personal service corporation (PSC), the taxable year determined under section 441(i) and § 1.441-3;

(C) In the case of a nuclear decommissioning fund, the taxable year determined under § 1.468A-4(c)(1);

(D) In the case of a designated settlement fund or a qualified settlement fund, the taxable year determined under § 1.468B-2(j);

(E) In the case of a common trust fund, the taxable year determined under section 584(i);

(F) In the case of certain trusts, the taxable year determined under section 644;

(G) In the case of a partnership, the taxable year determined under section 706 and § 1.706-1;

(H) In the case of an insurance company, the taxable year determined under section 843 and § 1.1502-76(a)(2);

(I) In the case of a real estate investment trust, the taxable year determined under section 859;

(J) In the case of a real estate mortgage investment conduit, the taxable year determined under section 860D(a)(5) and § 1.860D-1(b)(6);

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(K) In the case of a specified foreign corporation, the taxable year determined under section 898(c)(1)(A);

(L) In the case of an S corporation, the taxable year determined under section 1378 and § 1.1378-1; or

(M) In the case of a member of an affiliated group that makes a consolidated return, the taxable year determined under § 1.1502-76.

(ii) *Exceptions.* Notwithstanding paragraph (b)(2)(i) of this section, the following taxpayers may have a taxable year other than their required taxable year:

(A) *52-53-week taxable years.* Certain taxpayers may elect to use a 52-53-week taxable year that ends with reference to their required taxable year. See, for example, §§ 1.441-3 (PSCs), 1.706-1 (partnerships), 1.1378-1 (S corporations), and 1.1502-76(a)(1) (members of a consolidated group).

(B) *Partnerships, S corporations, and PSCs.* A partnership, S corporation, or PSC may use a taxable year other than its required taxable year if the taxpayer elects to use a taxable year other than its required taxable year under section 444, elects a 52-53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or to a taxable year elected under section 444, or establishes a business purpose to the satisfaction of the Commissioner under section 442 (such as a grandfathered fiscal year).

(C) *Specified foreign corporations.* A specified foreign corporation (as defined in section 898(b)) may use a taxable year other than its required taxable year if it elects a 52-53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or makes a one-month deferral election under section 898(c)(1)(B).

(3) *Annual accounting period.* *Annual accounting period* means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(4) *Calendar year.* *Calendar year* means a period of 12 consecutive months ending on December 31. A taxpayer who has not established a fiscal

year must make its return on the basis of a calendar year.

(5) *Fiscal year—(i) Definition.* *Fiscal year* means—

(A) A period of 12 consecutive months ending on the last day of any month other than December; or

(B) A 52-53-week taxable year, if such period has been elected by the taxpayer. See § 1.441-2.

(ii) *Recognition.* A fiscal year will be recognized only if the books of the taxpayer are kept in accordance with such fiscal year.

(6) *Grandfathered fiscal year.* *Grandfathered fiscal year* means a fiscal year (other than a year that resulted in a three month or less deferral of income) that a partnership or an S corporation received permission to use on or after July 1, 1974, by a letter ruling (i.e., not by automatic approval).

(7) *Books.* *Books* include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on the taxpayer's books and on the taxpayer's return, as for example, a reconciliation of any difference between such books and the taxpayer's return. Records that are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. See section 6001 and the regulations thereunder for rules relating to the keeping of books and records.

(8) *Taxpayer.* *Taxpayer* has the same meaning as the term *person* as defined in section 7701(a)(1) (e.g., an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term *taxpayer* as defined in section 7701(a)(14) (any person subject to tax).

(c) *Adoption of taxable year—(1) In general.* Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first Federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a Federal income tax return (e.g., Form

7004, “Application for Automatic Extension of Time to File Corporation Income Tax Return”), the filing of an application for an employer identification number (*i.e.*, Form SS-4, “Application for Employer Identification Number”), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

(2) *Approval required*—(i) *Taxpayers with required taxable years.* A newly-formed partnership, S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under section 444, or a 52-53-week taxable year that ends with reference to its required taxable year or a taxable year elected under section 444 must establish a business purpose and obtain the approval of the Commissioner under section 442.

(ii) *Taxpayers without books.* A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

(d) *Retention of taxable year.* In certain cases, a partnership, S corporation, electing S corporation, or PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that either becomes a PSC or elects to be an S corporation and, as a result, is required to use the calendar year under section 441(i) or 1378, respectively, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership. However, a partnership that previously established a business purpose to the satisfaction of the Commissioner to use a taxable year is not required to obtain the approval of the Commissioner if its required taxable year changes as a result of a change in ownership.

(e) *Change of taxable year.* Once a taxpayer has adopted a taxable year, such

taxable year must be used in computing taxable income and making returns for all subsequent years unless the taxpayer obtains approval from the Commissioner to make a change or the taxpayer is otherwise authorized to change without the approval of the Commissioner under the Internal Revenue Code (*e.g.*, section 444 or 859) or the regulations thereunder.

(f) *Obtaining approval of the Commissioner or making a section 444 election.* See § 1.442-1(b) for procedures for obtaining approval of the Commissioner (automatically or otherwise) to adopt, change, or retain an annual accounting period. See §§ 1.444-1T and 1.444-2T for qualifications, and 1.444-3T for procedures, for making an election under section 444.

[T.D. 8996, 67 FR 35012, May 17, 2002]

**§ 1.441-2 Election of taxable year consisting of 52-53 weeks.**

(a) *In general*—(1) *Election.* An eligible taxpayer may elect to compute its taxable income on the basis of a fiscal year that—

- (i) Varies from 52 to 53 weeks;
- (ii) Ends always on the same day of the week; and
- (iii) Ends always on—
  - (A) Whatever date this same day of the week last occurs in a calendar month; or
  - (B) Whatever date this same day of the week falls that is the nearest to the last day of the calendar month.

(2) *Effect.* In the case of a taxable year described in paragraph (a)(1)(iii)(A) of this section, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in paragraph (a)(1)(iii)(B) of this section, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(3) *Eligible taxpayer.* A taxpayer is eligible to elect a 52-53-week taxable year if such fiscal year would otherwise satisfy the requirements of section 441 and the regulations thereunder. For example, a taxpayer that is required to use a calendar year under § 1.441-1(b)(2)(i)(D) is not an eligible taxpayer.

(4) *Example.* The provisions of this paragraph (a) are illustrated by the following example:

*Example.* If the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 2001, the taxable year would end on November 24, 2001. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 2001, the taxable year would end on December 1, 2001.

(b) *Procedures to elect a 52-53-week taxable year—(1) Adoption of a 52-53-week taxable year—(i) In general.* A new eligible taxpayer elects a 52-53-week taxable year by adopting such year in accordance with § 1.441-1(c). A newly-formed partnership, S corporation or personal service corporation (PSC) may adopt a 52-53-week taxable year without the approval of the Commissioner if such year ends with reference to either the taxpayer's required taxable year (as defined in § 1.441-1(b)(2)) or the taxable year elected under section 444. See §§ 1.441-3, 1.706-1, and 1.1378-1. Similarly, a newly-formed specified foreign corporation (as defined in section 898(b)) may adopt a 52-53-week taxable year if such year ends with reference to the taxpayer's required taxable year, or, if the one-month deferral election under section 898(c)(1)(B) is made, with reference to the month immediately preceding the required taxable year. See § 1.1502-76(a)(1) for special rules regarding subsidiaries adopting 52-53-week taxable years.

(ii) *Filing requirement.* A taxpayer adopting a 52-53-week taxable year must file with its Federal income tax return for its first taxable year a statement containing the following information—

(A) The calendar month with reference to which the 52-53-week taxable year ends;

(B) The day of the week on which the 52-53-week taxable year always will end; and

(C) Whether the 52-53-week taxable year will always end on the date on which that day of the week last occurs in the calendar month, or on the date on which that day of the week falls that is nearest to the last day of that calendar month.

(2) *Change to (or from) a 52-53-week taxable year—(i) In general.* An election of a 52-53-week taxable year by an existing eligible taxpayer with an established taxable year is treated as a change in annual accounting period that requires the approval of the Commissioner in accordance with § 1.442-1. Thus, a taxpayer must obtain approval to change from its current taxable year to a 52-53-week taxable year, even if such 52-53-week taxable year ends with reference to the same calendar month. Similarly, a taxpayer must obtain approval to change from a 52-53-week taxable year, or to change from one 52-53-week taxable year to another 52-53-week taxable year. However, a taxpayer may obtain approval for 52-53-week taxable year changes automatically to the extent provided in administrative procedures published by the Commissioner. See § 1.442-1(b) for procedures for obtaining such approval.

(ii) *Special rules for the short period required to effect the change.* If a change to or from a 52-53-week taxable year results in a short period (within the meaning of § 1.443-1(a)) of 359 days or more, or six days or less, the tax computation under § 1.443-1(b) does not apply. If the short period is 359 days or more, it is treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but instead is added to and deemed a part of the following taxable year. (In the case of a change to or from a 52-53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under § 1.443-1(b) does not apply because the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days and less than 359 days, taxable income for the short period is placed on an annual basis for purposes of § 1.443-1(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period is the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless § 1.443-1(b)(2), relating to the alternative tax computation, applies). For an adjustment in deduction

for personal exemption, see § 1.443-1(b)(1)(v).

(3) *Examples.* The following examples illustrate paragraph (b)(2)(ii) of this section:

*Example 1.* A taxpayer having a fiscal year ending April 30, obtains approval to change to a 52-53-week taxable year ending the last Saturday in April for taxable years beginning after April 30, 2001. This change involves a short period of 362 days, from May 1, 2001, to April 27, 2002, inclusive. Because the change results in a short period of 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

*Example 2.* Assume the same conditions as *Example 1*, except that the taxpayer changes for taxable years beginning after April 30, 2002, to a taxable year ending on the Thursday nearest to April 30. This change results in a short period of two days, May 1 to May 2, 2002. Because the short period is less than seven days, tax is not separately computed. This short period is added to and deemed part of the following 52-53-week taxable year, which would otherwise begin on May 3, 2002, and end on May 1, 2003.

(c) *Application of effective dates—(1) In general.* Except as provided in paragraph (c)(3) of this section, for purposes of determining the effective date (*e.g.*, of legislative, regulatory, or administrative changes) or the applicability of any provision of the internal revenue laws that is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52-53-week taxable year is deemed to begin on the first day of the calendar month nearest to the first day of the 52-53-week taxable year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52-53-week taxable year, as the case may be. Examples of provisions of this title, the applicability of which is expressed in terms referred to in the preceding sentence, include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II, subchapter B, chapter 6 (section 1561 and following) relating to surtax exemptions of certain controlled corporations.

(2) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

*Example 1.* Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 2001. For that purpose, a 52-53-week taxable year beginning on any day within the period December 26, 2000, to January 4, 2001, inclusive, is treated as beginning on January 1, 2001.

*Example 2.* Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52-53-week taxable year ending on any day during the period May 25 to June 3, inclusive, is treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

*Example 3.* Assume that a revenue procedure requires the performance of an act by the taxpayer within “the first 90 days of the taxable year,” by “the 75th day of the taxable year,” or, alternately, by “the last day of the taxable year.” The taxpayer employs a 52-53-week taxable year that ends always on the Saturday closest to the last day of December. These requirements are not expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, and are accordingly outside the scope of the rule stated in § 1.441-2(c)(1). Accordingly, the taxpayer must perform the required act by the 90th, 75th, or last day, respectively, of its taxable year.

*Example 4.* X, a corporation created on January 1, 2001, elects a 52-53-week taxable year ending on the Friday nearest the end of December. Thus, X’s first taxable year begins on Monday, January 1, 2001, and ends on Friday, December 28, 2001; its next taxable year begins on Saturday, December 29, 2001, and ends on Friday, January 3, 2003; and its next taxable year begins on Saturday, January 4, 2003, and ends on Friday, January 2, 2004. For purposes of applying the provisions of part II, subchapter B, chapter 6 of the Internal Revenue Code, X’s first taxable year is deemed to end on December 31, 2001; its next taxable year is deemed to begin on January 1, 2002, and end on December 31, 2002, and its next taxable year is deemed to begin on January 1, 2003, and end on December 31, 2003. Accordingly, each such taxable year is treated as including one and only one December 31st.

(3) *Changes in tax rates.* If a change in the rate of tax is effective during a 52-53-week taxable year (other than on the first day of such year as determined under paragraph (c)(1) of this section), the tax for the 52-53-week taxable year must be computed in accordance with section 15, relating to effect

of changes, and the regulations thereunder. For the purpose of the computation under section 15, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of paragraph (b)(1) of this paragraph.

(4) *Examples.* The provisions of paragraph (c)(3) of this section may be illustrated by the following examples:

*Example 1.* Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2002. For a 52-53-week taxable year beginning on Friday, November 2, 2001, the tax must be computed on the basis of the old rates for the actual number of days from November 2, 2001, to June 30, 2002, inclusive, and on the basis of the new rates for the actual number of days from July 1, 2002, to Thursday, October 31, 2002, inclusive.

*Example 2.* Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2001. For this purpose, a 52-53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 15 will be required for such year because of the change in rate.

(d) *Computation of taxable income.* The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, generally are applicable to 52-53-week taxable years. Thus, except as otherwise provided, all items of income and deduction must be determined on the basis of a 52-53-week taxable year. However, a taxpayer may determine particular items as though the 52-53-week taxable year were a taxable year consisting of 12 calendar months, provided that practice is consistently followed by the taxpayer and clearly reflects income. For example, an allowance for depreciation or amortization may be determined on the basis of a 52-53-week taxable year, or as though the 52-53-week taxable year is a taxable year consisting of 12 calendar months, provided the taxpayer consistently follows that practice with respect to all depreciable or amortizable items.

(e) *Treatment of taxable years ending with reference to the same calendar month—(1) Pass-through entities.* If a pass-through entity (as defined in paragraph (e)(3)(i) of this section) or an

owner of a pass-through entity (as defined in paragraph (e)(3)(ii) of this section), or both, use a 52-53-week taxable year and the taxable year of the pass-through entity and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year. Thus, if the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which that partner takes into account items described in section 702 and items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of that partner, that partner's taxable year will be deemed to end on the last day of the partnership's taxable year. Similarly, if the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which that shareholder takes into account items described in section 1366(a) and items that are deductible by the S corporation and includible in the income of that shareholder, that shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(2) *Personal service corporations and employee-owners.* If the taxable year of a PSC (within the meaning of §1.441-3(c)) and an employee-owner (within the meaning of §1.441-3(g)) end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the PSC and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the PSC's taxable year.

(3) *Definitions—(i) Pass-through entity.* For purposes of this section, a pass-through entity means a partnership, S corporation, trust, estate, closely-held real estate investment trust (within the meaning of section 6655(e)(5)(B)),

common trust fund (within the meaning of section 584(i)), controlled foreign corporation (within the meaning of section 957), foreign personal holding company (within the meaning of section 552), or passive foreign investment company that is a qualified electing fund (within the meaning of section 1295).

(ii) *Owner of a pass-through entity.* For purposes of this section, an owner of a pass-through entity generally means a taxpayer that owns an interest in, or stock of, a pass-through entity. For example, an owner of a pass-through entity includes a partner in a partnership, a shareholder of an S corporation, a beneficiary of a trust or an estate, an owner of a closely-held real estate investment trust (within the meaning of section 6655(e)(5)(A)), a participant in a common trust fund, a U.S. shareholder (as defined in section 951(b)) of a controlled foreign corporation, a U.S. shareholder (as defined in section 551(a)) of a foreign personal holding company, or a U.S. person that holds stock in a passive foreign investment company that is a qualified electing fund with respect to that shareholder.

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

*Example 1.* ABC Partnership uses a 52-53-week taxable year that ends on the Wednesday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 2001, each partner's distributive share of ABC's taxable income is \$10,000. Under section 706(a) and paragraph (e)(1) of this section, for the taxable year ending December 31, 2000, A, B, and C each must include \$10,000 in income with respect to the ABC year ending January 3, 2001. Similarly, if ABC makes a guaranteed payment to A on January 2, 2001, A must include the payment in income for A's taxable year ending December 31, 2000.

*Example 2.* X, a PSC, uses a 52-53-week taxable year that ends on the Wednesday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 2001, X pays a bonus of \$10,000 to each employee-owner on January 2, 2001. Under paragraph (e)(2) of this section, each employee-owner must include its bonus in income for the taxable year ending December 31, 2000.

(5) *Transition rule.* In the case of an owner of a pass-through entity (other than the owner of a partnership or S corporation) that is required by this paragraph (e) to include in income for its first taxable year ending on or after May 17, 2002 amounts attributable to two taxable years of a pass-through entity, the amount that otherwise would be required to be included in income for such first taxable year by reason of this paragraph (e) should be included in income ratably over the four-taxable-year period beginning with such first taxable year under principles similar to § 1.702-3T, unless the owner of the pass-through entity elects to include all such income in its first taxable year ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35012, May 17, 2002]

#### § 1.441-3 Taxable year of a personal service corporation.

(a) *Taxable year—(1) Required taxable year.* Except as provided in paragraph (a)(2) of this section, the taxable year of a personal service corporation (PSC) (as defined in paragraph (c) of this section) must be the calendar year.

(2) *Exceptions.* A PSC may have a taxable year other than its required taxable year (i.e., a fiscal year) if it makes an election under section 444, elects to use a 52-53-week taxable year that ends with reference to the calendar year or a taxable year elected under section 444, or establishes a business purpose for such fiscal year and obtains the approval of the Commissioner under section 442.

(b) *Adoption, change, or retention of taxable year—(1) Adoption of taxable year.* A PSC may adopt, in accordance with § 1.441-1(c), the calendar year, a taxable year elected under section 444, or a 52-53-week taxable year ending with reference to the calendar year or a taxable year elected under section 444 without the approval of the Commissioner. See § 1.441-1. A PSC that wants to adopt any other taxable year must establish a business purpose and obtain the approval of the Commissioner under section 442.

(2) *Change in taxable year.* A PSC that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, a

PSC may obtain automatic approval for certain changes, including a change to the calendar year or to a 52-53-week taxable year ending with reference to the calendar year, pursuant to administrative procedures published by the Commissioner.

(3) *Retention of taxable year.* In certain cases, a PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that becomes a PSC and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(4) *Procedures for obtaining approval or making a section 444 election.* See § 1.442-1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444-1T and 1.444-2T for qualifications, and 1.444-3T for procedures, for making an election under section 444.

(5) *Examples.* The provisions of paragraph (b)(4) of this section may be illustrated by the following examples:

*Example 1.* X, whose taxable year ends on January 31, 2001, becomes a PSC for its taxable year beginning February 1, 2001, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, for taxable years ending before February 1, 2001, this section does not apply with respect to X. For its taxable year beginning on February 1, 2001, however, X will be required to comply with paragraph (a) of this section. Thus, unless X obtains approval of the Commissioner to use a January 31 taxable year, or makes a section 444 election, X will be required to change its taxable year to the calendar year under paragraph (b) of this section by using a short taxable year that begins on February 1, 2001, and ends on December 31, 2001. Under paragraph (b)(1) of this section, X may obtain automatic approval to change its taxable year to a calendar year. See § 1.442-1(b).

*Example 2.* Assume the same facts as in *Example 1*, except that X desires to change to a 52-53-week taxable year ending with reference to the month of December. Under paragraph (b)(1) of this section X may obtain automatic approval to make the change. See § 1.442-1(b).

(c) *Personal service corporation defined—(1) In general.* For purposes of

this section and section 442, a taxpayer is a PSC for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period is the performance of personal services;

(iii) During the testing period, those services are substantially performed by employee-owners (as defined in paragraph (g) of this section); and

(iv) Employee-owners own (as determined under the attribution rules of section 318, except that the language “any” applies instead of “50 percent” in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period.

(2) *Testing period—(i) In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, the testing period for any taxable year is the immediately preceding taxable year.

(ii) *New corporations.* The testing period for a taxpayer’s first taxable year is the period beginning on the first day of that taxable year and ending on the earlier of—

(A) The last day of that taxable year; or

(B) The last day of the calendar year in which that taxable year begins.

(3) *Examples.* The provisions of paragraph (c)(2)(ii) of this section may be illustrated by the following examples:

*Example 1.* Corporation A’s first taxable year begins on June 1, 2001, and A desires to use a September 30 taxable year. However, if A is a personal service corporation, it must obtain the Commissioner’s approval to use a September 30 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A’s testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001 through September 30, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner’s permission to use a September 30 taxable year.

*Example 2.* The facts are the same as in *Example 1*, except that A desires to use a March 31 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A’s testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001, through December 31, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner’s permission to use a March 31 taxable year.

(d) *Performance of personal services—*  
 (1) *Activities described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in § 1.448-1T) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(e) *Principal activity—*(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be the performance of personal services if the cost of the corporation's compensation (the compensation cost) for such testing period that is attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (i.e., the total compensation for personal service activities) exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost—*(i) *Amounts included.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(A) Wages and salaries; and

(B) Any other amounts, attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (g)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation in-

cludible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

(ii) *Amounts excluded.* Notwithstanding paragraph (e)(2)(i) of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity—*(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (d) of this section, or employees involved only in supporting the work of such employees, are considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (d) of this section, or for employees involved only in supporting the work of such employees, are not considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (e)(3)(i) or (ii) of this section (a mixed-activity employee) is allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for that employee multiplied by the percentage of the total time worked for the corporation by that employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (d) of this section. That percentage is to be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is not considered to be attributable to the corporation's personal service activity is the compensation cost for that employee less the amount determined in paragraph (e)(3)(iii)(A) of this section.

(f) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for that period attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (*i.e.*, the total compensation for personal service activities) is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (f)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services is determined under paragraph (e)(3) of this section; and

(ii) The portion of the amount determined under paragraph (f)(2)(i) of this section that is attributable to personal services performed by employee-owners is to be determined by the taxpayer in any reasonable and consistent manner.

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

*Example 1.* For its taxable year beginning February 1, 2001, Corp A's testing period is the taxable year ending January 31, 2000. During that testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was \$1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was \$210,000. Pursuant to paragraph (f)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

*Example 2.* Corp B has the same facts as corporation A in *Example 1*, except that dur-

ing the taxable year ending January 31, 2001, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was \$1,500,000 (\$1,000,000 attributable to B's personal service activity and \$500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was \$250,000 (\$210,000 attributable to B's personal service activity and \$40,000 attributable to B's other activity). Pursuant to paragraph (f)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners (\$210,000).

(g) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period; and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (g)(1)(ii) of this section and who performs personal services for, or on behalf of, the corporation is treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

(h) *Special rules for affiliated groups filing consolidated returns*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group are treated as a single corporation;

(ii) The employees of the members of the affiliated group are treated as employees of such single corporation; and

(iii) All of the stock of the members of the affiliated group that is not

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owned by any other member of the affiliated group is treated as the outstanding stock of that corporation.

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

*Example 1.* The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 2001, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 2001. During the testing period (i.e., the taxable year ending January 31, 2001), A did not perform personal services. However, B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A. However, some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (h)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Because the only employee-owners of AB are the employees of B, and because B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not a PSC subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, its principal activity is the providing of personal services, or the personal services are substantially performed by employee-owners.

*Example 2.* The facts are the same as in Example 1, except that on the last day of the testing period A owns only 80 percent of B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is \$1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is \$50,000 as of the last day of the testing period. Pursuant to paragraphs (c)(1)(iv) and (h)(1) of this section, AB must determine whether the employee-owners of A and B (i.e., B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Because the \$140,000 [ $(\$1,000,000 \times .09) + \$50,000$ ] fair market value of the stock held by B's employees is greater than 10 percent of the aggregate fair market value of A and B as of the last day of the testing period, or \$105,000 [ $\$1,000,000 + \$50,000 \times .10$ ], AB may be subject to this section if, on a consolidated basis during the testing period, the principal activity of AB is the performance of personal services

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and the personal services are substantially performed by employee-owners.

[T.D. 8996, 67 FR 35012, May 17, 2002]

### § 1.441-4 Effective date.

Sections 1.441-0 through 1.441-3 are applicable for taxable years ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35012, May 17, 2002]

### § 1.442-1 Change of annual accounting period.

(a) *Approval of the Commissioner.* A taxpayer that has adopted an annual accounting period (as defined in § 1.441-1(b)(3)) as its taxable year generally must continue to use that annual accounting period in computing its taxable income and for making its Federal income tax returns. If the taxpayer wants to change its annual accounting period and use a new taxable year, it must obtain the approval of the Commissioner, unless it is otherwise authorized to change without the approval of the Commissioner under either the Internal Revenue Code (e.g., section 444 and section 859) or the regulations thereunder (e.g., paragraph (c) of this section). In addition, as described in § 1.441-1(c) and (d), a partnership, S corporation, electing S corporation, or personal service corporation (PSC) generally is required to secure the approval of the Commissioner to adopt or retain an annual accounting period other than its required taxable year. The manner of obtaining approval from the Commissioner to adopt, change, or retain an annual accounting period is provided in paragraph (b) of this section. However, special rules for obtaining approval may be provided in other sections.

(b) *Obtaining approval—(1) Time and manner for requesting approval.* In order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128, "Application To Adopt, Change, or Retain a Tax Year," with the Commissioner within such time and in such manner as is provided in administrative procedures published by the Commissioner.

(2) *General requirements for approval.* An adoption, change, or retention in

annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention. In determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. Generally, the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year (as defined in §1.441-1(b)(2)), ownership taxable year, or natural business year. In the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose.

(3) *Administrative procedures.* The Commissioner will prescribe administrative procedures under which a taxpayer may be permitted to adopt, change, or retain an annual accounting period. These administrative procedures will describe the business purpose requirements (including an ownership taxable year and a natural business year) and the terms, conditions, and adjustments necessary to obtain approval. Such terms, conditions, and adjustments may include adjustments necessary to neutralize the tax effects of a substantial distortion of income that would otherwise result from the requested annual accounting period including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary in an estate; the creation of a short period in which there is a substantial net operating loss, capital loss, or credit (including a general business credit); or the creation of a short period in which there is a substantial amount of income to offset an

expiring net operating loss, capital loss, or credit. See, for example, Rev. Proc. 2002-39, 2002-22 I.R.B., procedures for obtaining the Commissioner's prior approval of an adoption, change, or retention in annual accounting period through application to the national office; Rev. Proc. 2002-37, 2002-22 I.R.B., automatic approval procedures for certain corporations; Rev. Proc. 2002-38, 2002-22 I.R.B., automatic approval procedures for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66-50, 1966-2 C.B. 1260, automatic approval procedures for individuals. For availability of Revenue Procedures and Notices, see §601.601(d)(2) of this chapter.

(4) *Taxpayers to whom section 441(g) applies.* If section 441(g) and §1.441-1(b)(1)(iv) apply to a taxpayer, the adoption of a fiscal year is treated as a change in the taxpayer's annual accounting period under section 442. Therefore, that fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. In addition to any other terms and conditions that may apply to such a change, the taxpayer must establish and maintain books that adequately and clearly reflect income for the short period involved in the change and for the fiscal year proposed.

(c) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation that is required to change its annual accounting period under §1.1502-76, relating to the taxable year of members of an affiliated group that file a consolidated return, does not need to obtain the approval of the Commissioner or file an application on Form 1128 with respect to that change.

(d) *Special rule for newly married couples.* (1) A newly married husband or wife may obtain automatic approval under this paragraph (d) to change his or her annual accounting period in order to use the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of that spouse ending after the date of marriage. Such automatic approval will be granted only if the newly married husband or wife adopting the annual accounting period

of the other spouse files a Federal income tax return for the short period required by that change on or before the 15th day of the 4th month following the close of the short period. See section 443 and the regulations thereunder. If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph (d). The short-period return must contain a statement at the top of page one of the return that it is filed under the authority of this paragraph (d). The newly married husband or wife need not file Form 1128 with respect to a change described in this paragraph (d). For a change of annual accounting period by a husband or wife that does not qualify under this paragraph (d), see paragraph (b) of this section.

(2) The provisions of this paragraph (d) may be illustrated by the following example:

*Example.* H & W marry on September 25, 2001. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 2001. H may not change to a calendar year for 2001 since, under this paragraph (d), he would have had to file a return for the short period from July 1 to December 31, 2000, by April 16, 2001. Since the date of marriage occurred subsequent to this due date, the return could not be filed under this paragraph (d). Therefore, H cannot change to a calendar year for 2001. However, H may change to a calendar year for 2002 by filing a return under this paragraph (d) by April 15, 2002, for the short period from July 1 to December 31, 2001. If H files such a return, H and W may file a joint return for calendar year 2002 (which is W's second taxable year ending after the date of marriage).

(e) *Effective date.* The rules of this section are applicable for taxable years ending on or after May 17, 2002.

[T.D. 8996, 67 FR 35019, May 17, 2002]

#### **§ 1.443-1 Returns for periods of less than 12 months.**

(a) *Returns for short period.* A return for a short period, that is, for a taxable year consisting of a period of less than 12 months, shall be made under any of the following circumstances:

(1) *Change of annual accounting period.* In the case of a change in the annual accounting period of a taxpayer, a separate return must be filed for the short period of less than 12 months beginning with the day following the close of the old taxable year and ending with the day preceding the first day of the new taxable year. However, such a return is not required for a short period of six days or less, or 359 days or more, resulting from a change from or to a 52-53-week taxable year. See section 441(f) and § 1.441-2. The computation of the tax for a short period required to effect a change of annual accounting period is described in paragraph (b) of this section. In general, a return for a short period resulting from a change of annual accounting period shall be filed and the tax paid within the time prescribed for filing a return for a taxday of the short period. For rules applicable to a subsidiary corporation which becomes a member of an affiliated group which files a consolidated return, see § 1.1502-76.

(2) *Taxpayer not in existence for entire taxable year.* If a taxpayer is not in existence for the entire taxable year, a return is required for the short period during which the taxpayer was in existence. For example, a corporation organized on August 1 and adopting the calendar year as its annual accounting period is required to file a return for the short period from August 1 to December 31, and returns for each calendar year thereafter. Similarly, a dissolving corporation which files its returns for the calendar year is required to file a return for the short period from January 1 to the date it goes out of existence. Income for the short period is not required to be annualized if the taxpayer is not in existence for the entire taxable year, and, in the case of a taxpayer other than a corporation, the deduction under section 151 for personal exemptions (or deductions in lieu thereof) need not be reduced under section 443(c). In general, the requirements with respect to the filing of returns and the payment of tax for a short period where the taxpayer has not been in existence for the entire taxable year are the same as for the filing of a return and the payment of tax for a taxable year of 12 months ending

on the last day of the short period. Although the return of a decedent is a return for the short period beginning with the first day of his last taxable year and ending with the date of his death, the filing of a return and the payment of tax for a decedent may be made as though the decedent had lived throughout his last taxable year.

(b) *Computation of tax for short period on change of annual accounting period—*

(1) *General rule.* (i) If a return is made for a short period resulting from a change of annual accounting period, the taxable income for the short period shall be placed on an annual basis by multiplying such income by 12 and dividing the result by the number of months in the short period. Unless section 443(b)(2) and subparagraph (2) of this paragraph apply, the tax for the short period shall be the same part of the tax computed on the annual basis as the number of months in the short period is of 12 months.

(ii) If a return is made for a short period of more than 6 days, but less than 359 days, resulting from a change from or to a 52-53-week taxable year, the taxable income for the short period shall be annualized and the tax computed on a daily basis, as provided in section 441(f)(2)(B)(iii) and §1.441-2(b)(2)(ii).

(iii) For method of computation of income for a short period in the case of a subsidiary corporation required to change its annual accounting period to conform to that of its parent, see §1.1502-76(b).

(iv) An individual taxpayer making a return for a short period resulting from a change of annual accounting period is not allowed to take the standard deduction provided in section 141 in computing his taxable income for the short period. See section 142(b)(3).

(v) In computing the taxable income of a taxpayer other than a corporation for a short period (which income is to be annualized in order to determine the tax under section 443(b)(1)) the personal exemptions allowed individuals under section 151 (and any deductions allowed other taxpayers in lieu thereof, such as the deduction under section 642(b)) shall be reduced to an amount which bears the same ratio to the full amount of the exemptions as the number of

months in the short period bears to 12. In the case of the taxable income for a short period resulting from a change from or to a 52-53-week taxable year to which section 441(f)(2)(B)(iii) applies, the computation required by the preceding sentence shall be made on a daily basis, that is, the deduction for personal exemptions (or any deduction in lieu thereof) shall be reduced to an amount which bears the same ratio to the full deduction as the number of days in the short period bears to 365.

(vi) If the amount of a credit against the tax (for example, the credits allowable under section 34 (for dividends received on or before December 31, 1964), and 35 (for partially tax-exempt interest)) is dependent upon the amount of any item of income or deduction, such credit shall be computed upon the amount of the item annualized separately in accordance with the foregoing rules. The credit so computed shall be treated as a credit against the tax computed on the basis of the annualized taxable income. In any case in which a limitation on the amount of a credit is based upon taxable income, taxable income shall mean the taxable income computed on the annualized basis.

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

*Example 1.* A taxpayer with one dependent who has been granted permission under section 442 to change his annual accounting period files a return for the short period of 10 months ending October 31, 1956. He has income and deductions as follows:

<i>Income</i>		
Interest income .....		\$10,000.00
Partially tax-exempt interest with respect to which a credit is allowable under section 35 .....		500.00
Dividends to which sections 34 and 116 are applicable .....		750.00
		11,250.00
<i>Deductions</i>		
Real estate taxes .....		200.00
2 personal exemptions at \$600 on an annual basis .....		1,200.00
The tax for the 10-month period is computed as follows:		
Total income as above ..		11,250.00
Less:		
Exclusion for dividends received .....	\$50.00	
2 personal exemptions (\$1,200× <sup>10</sup> / <sub>12</sub> ) .....		1,000.00

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Real estate taxes .....	200.00	
		1,250.00
Taxable income for 10-month period before annualizing .....		10,000.00
Taxable income annualized (10,000×1 <sup>2</sup> / <sub>10</sub> ) .....		12,000.00
Tax on \$12,000 before credits .....		3,400.00
Deduct credits:		
Dividends received for 10-month period .....	\$750.00	
Less: Excluded portion .....	50.00	
		700.00
Included in gross income .....	700.00	
Dividend income annualized (\$700×1 <sup>2</sup> / <sub>10</sub> ) .....	840.00	
Credit (4 percent of \$840) .....		33.60
Partially tax-exempt interest included in gross income for 10-month period .....	500.00	
Partially tax-exempt interest (annualized) (\$500×1 <sup>2</sup> / <sub>10</sub> ) .....	600.00	
Credit (3 percent of \$600) .....		18.00
		51.60
Tax on \$12,000 (after credits) .....		3,348.40
Tax for 10-month period (\$3,348.40×1 <sup>9</sup> / <sub>12</sub> ) .....		2,790.33

*Example 2.* The X Corporation makes a return for the one-month period ending September 30, 1956, because of a change in annual accounting period permitted under section 442. Income and expenses for the short period are as follows:

Gross operating income .....	\$126,000
Business expenses .....	130,000
Net loss from operations .....	(4,000)
Dividends received from taxable domestic corporations .....	30,000
Gross income for short period before annualizing .....	26,000
Dividends received deduction (85 percent of \$30,000, but not in excess of 85 percent of \$26,000) .....	22,100
Taxable income for short period before annualizing .....	3,900
Taxable income annualized (\$8,900×12) .....	46,800
Tax on annual basis:	
\$46,800 at 52 percent .....	\$24,336
Less surtax exemption .....	5,500
	\$18,836
Tax for 1-month period (\$18,836×1 <sup>1</sup> / <sub>12</sub> ) .....	1,570

*Example 3.* The Y Corporation makes a return for the six-month period ending June 30, 1957, because of a change in annual accounting period permitted under section 442. Income for the short period is as follows:

Taxable income exclusive of net long-term capital gain .....	\$40,000
Net long-term capital gain .....	10,000
Taxable income for short period before annualizing .....	50,000
Taxable income annualized (\$50,000×1 <sup>2</sup> / <sub>6</sub> ) .....	100,000
<i>Regular tax computation</i>	
Taxable income annualized .....	100,000
Tax on annual basis:	
\$100,000 at 52 percent .....	\$52,000
Less surtax exemption .....	5,500
	46,500
Tax for 6-month period (\$46,500×6 <sup>1</sup> / <sub>12</sub> ) .....	23,250
<i>Alternative tax computation</i>	
Taxable income annualized .....	100,000
Less annualized capital gain (\$10,000×1 <sup>2</sup> / <sub>6</sub> ) .....	20,000
Annualized taxable income subject to partial tax .....	80,000
<i>Partial tax on annual basis</i>	
\$60,000 at 52 percent .....	\$41,600
Less surtax exemption .....	5,500
	36,100
25 percent of annualized capital gain (\$20,000) ...	5,000
Alternative tax on annual basis .....	41,100
Alternative tax for 6-month period (\$41,100×6 <sup>1</sup> / <sub>12</sub> ) .....	20,550

Since the alternative tax of \$20,550 is less than the tax computed in the regular manner (\$23,250), the corporation's tax for the 6-month short period is \$20,550.

(2) *Exception: computation based on 12-month period.* (i) A taxpayer whose tax would otherwise be computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52-53-week taxable year) for the short period resulting from a change of annual accounting period may apply to the district director to have his tax computed under the provisions of section 443(b)(2) and this subparagraph. If such application is made, as provided in subdivision (v) of this subparagraph, and if the taxpayer establishes the amount of his taxable income for the 12-month period described in subdivision (ii) of this subparagraph, then the tax for the short period shall be the greater of the following—

(a) An amount which bears the same ratio to the tax computed on the taxable income which the taxpayer has established for the 12-month period as the taxable income computed on the basis of the short period bears to the taxable income for such 12-month period; or

(b) The tax computed on the taxable income for the short period without placing the taxable income on an annual basis.

However, if the tax computed under section 443(b)(2) and this subparagraph is not less than the tax for the short period computed under section 443(b)(1) (or section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52-53-week taxable year), then section 443(b)(2) and this subparagraph do not apply.

(ii) The term "12-month period" referred to in subdivision (i) of this subparagraph means the 12-month period beginning on the first day of the short period. However, if the taxpayer is not in existence at the end of such 12-month period, or if the taxpayer is a corporation which has disposed of substantially all of its assets before the end of such 12-month period, the term "12-month period" means the 12-month period ending at the close of the last day of the short period. For the purposes of the preceding sentence, a corporation which has ceased business and distributed so much of the assets used in its business that it cannot resume its customary operations with the remaining assets, will be considered to have disposed of substantially all of its assets. In the case of a change from a 52-53-week taxable year, the term "12-month period" means the period of 52 or 53 weeks (depending on the taxpayer's 52-53-week taxable year) beginning on the first day of the short period.

(iii)(a) The taxable income for the 12-month period is computed under the same provisions of law as are applicable to the short period and is computed as if the 12-month period were an actual annual accounting period of the taxpayer. All items which fall in such 12-month period must be included even if they are extraordinary in amount or of an unusual nature. If the taxpayer is a member of a partnership, his taxable income for the 12-month period shall include his distributive share of partnership income for any taxable year of the partnership ending within or with such 12-month period, but no amount shall be included with respect to a taxable year of the partnership ending before or after such 12-month period. If any other item partially applicable to

such 12-month period can be determined only at the end of a taxable year which includes only part of the 12-month period, the taxpayer, subject to review by the Commissioner, shall apportion such item to the 12-month period in such manner as will most clearly reflect income for the 12-month period.

(b) In the case of a taxpayer permitted or required to use inventories, the cost of goods sold during a part of the 12-month period included in a taxable year shall be considered, unless a more exact determination is available, as such part of the cost of goods sold during the entire taxable year as the gross receipts from sales for such part of the 12-month period is of the gross receipts from sales for the entire taxable year. For example, the 12-month period of a corporation engaged in the sale of merchandise, which has a short period from January 1, 1956, to September 30, 1956, is the calendar year 1956. The three-month period, October 1, 1956, to December 31, 1956, is part of the taxpayer's taxable year ending September 30, 1957. The cost of goods sold during the three-month period, October 1, 1956, to December 31, 1956, is such part of the cost of goods sold during the entire fiscal year ending September 30, 1957, as the gross receipts from sales for such three-month period are of the gross receipts from sales for the entire fiscal year.

(c) The Commissioner may, in granting permission to a taxpayer to change his annual accounting period, require, as a condition to permitting the change, that the taxpayer must take a closing inventory upon the last day of the 12-month period if he wishes to obtain the benefits of section 443(b)(2). Such closing inventory will be used only for the purposes of section 443(b)(2), and the taxpayer will not be required to use such inventory in computing the taxable income for the taxable year in which such inventory is taken.

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

*Example 1.* The taxpayer in Example 1 under paragraph (b)(1)(vii) of this section establishes his taxable income for the 12-

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month period from January 1, 1956, to December 31, 1956. The taxpayer has a short period of 10 months, from January 1, 1956, to October 31, 1956. The taxpayer files an application in accordance with subdivision (v) of this subparagraph to compute his tax under section 443(b)(2). The taxpayer's income and deductions for the 12-month period, as so established, follow:

<i>Income</i>	
Interest income .....	\$11,000
Partially tax-exempt interest with respect to which a credit is allowable under section 35 .....	600
Dividends to which sections 34 and 116 are applicable .....	850
	12,450
<i>Deductions</i>	
Real estate taxes .....	200
2 personal exemptions at \$600 .....	1,200
<i>Tax computation for short period under section 443(b)(2)(A)(i)</i>	
Total income as above .....	\$12,450
Less:	
Exclusion for dividends received .....	\$50
Personal exemptions .....	1,200
Deduction for taxes .....	200
	1,450
Taxable income for 12-month period .....	11,000
Tax before credits .....	3,020
Credit for partially tax-exempt interest (3 percent of \$600) .....	18
Credit for dividends received (4 percent of (\$850 - 50)) .....	32
	50
Tax under section 443(b)(2)(A)(i) for 12-month period .....	2,970
Taxable income for 10-month short period from Example 1 of paragraph (b)(1)(vii) of this section before annualizing .....	10,000
Tax for short period under section 443(b)(2)(A)(i) (\$2,970×\$10,000 (taxable income for short period)/\$11,000 (taxable income for 12-month period)) .....	2,700
<i>Tax computation for short period under section 443(b)(2)(A)(ii)</i>	
Total income for 10-month short period .....	11,250
Less:	
Exclusion for dividends received .....	50
2 personal exemptions .....	1,200
Real estate taxes .....	200
	1,450
Taxable income for short period without annualizing and without proration of personal exemptions .....	9,800
Tax before credits .....	2,572
Less credits:	
Partially tax-exempt interest (3 percent of \$500) .....	15
Dividends received (4 percent of (\$750 - 50)) .....	28
	43
Tax for short period under section 443(b)(2)(A)(ii) .....	2,529

The tax of \$2,700 computed under section 443(b)(2)(A)(i) is greater than the tax of \$2,529, computed under section 443(b)(2)(A)(ii), and is, therefore, the tax under section 443(b)(2). Since the tax of \$2,700 (computed under section 443(b)(2)) is less than the tax of \$2,790.33 (computed under section 443(b)(1)) on the annualized income of the short period (see Example 1 of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is \$2,700.

*Example 2.* Assume the same facts as in Example 1 of this subdivision, except that, during the month of November 1956, the taxpayer suffered a casualty loss of \$5,000. The tax computation for the short period under section 443(b)(2) would be as follows:

<i>Tax computation for short period under section 443(b)(2)(A)(i)</i>	
Taxable income for 12-month period from Example 1 .....	\$11,000
Less: Casualty loss .....	5,000
	6,000
Taxable income for 12-month period .....	6,000
Tax before credits .....	\$1,360
Credits from Example 1 .....	50
	1,310
Tax under section 443(b)(2)(A)(i) for 12-month period .....	1,310
Tax for short period (\$1,310×\$10,000/\$6,000) under section 443(b)(2)(A)(i) .....	2,183
<i>Tax computation for short period under section 443(b)(2)(A)(ii)</i>	
Total income for the short period .....	11,250
Less:	
Exclusion for dividends received .....	50
2 personal exemptions .....	1,200
Real estate taxes .....	200
	1,450
Taxable income for short period without annualizing and without proration of personal exemptions .....	9,800
Tax before credits .....	2,572
Less credits:	
Partially tax-exempt interest (3 percent of \$500) .....	15
Dividends received (4 percent of \$750 - 50)) .....	28
	43
Tax for short period under section 443(b)(2)(A)(ii) .....	2,529

The tax of \$2,529, computed under section 443(b)(2)(A)(ii) is greater than the tax of \$2,183 computed under section 443(b)(2)-(A)(i) and is, therefore, the tax under section 443(b)(2). Since this tax is less than the tax of \$2,790.33, computed under section 443(b)(1) (see Example 1 of paragraph (b)(1)(vii) of this section), the taxpayer's tax for the 10-month short period is \$2,529.

(v)(a) A taxpayer who wishes to compute his tax for a short period resulting from a change of annual accounting period under section 443(b)(2) must make

an application therefor. Except as provided in (b) of this subdivision, the taxpayer shall first file his return for the short period and compute his tax under section 443(b)(1). The application for the benefits of section 443(b)(2) shall subsequently be made in the form of a claim for credit or refund. The claim shall set forth the computation of the taxable income and the tax thereon for the 12-month period and must be filed not later than the time (including extensions) prescribed for filing the return for the taxpayer's first taxable year which ends on or after the day which is 12 months after the beginning of the short period. For example, assume that a taxpayer changes his annual accounting period from the calendar year to a fiscal year ending September 30, and files a return for the short period from January 1, 1956, to September 30, 1956. His application for the benefits of section 443(b)(2) must be filed not later than the time prescribed for filing his return for his first taxable year which ends on or after the last day of December 1956, the twelfth month after the beginning of the short period. Thus, the taxpayer must file his application not later than the time prescribed for filing the return for his fiscal year ending September 30, 1957. If he obtains an extension of time for filing the return for such fiscal year, he may file his application during the period of such extension. If the district director determines that the taxpayer has established the amount of his taxable income for the 12-month period, any excess of the tax paid for the short period over the tax computed under section 443(b)(2) will be credited or refunded to the taxpayer in the same manner as in the case of an overpayment.

(b) If at the time the return for the short period is filed, the taxpayer is able to determine that the 12-month period ending with the close of the short period (see section 443(b)(2)-(B)(ii) and subparagraph (2)(ii) of this paragraph) will be used in the computations under section 443(b)(2), then the tax on the return for the short period may be determined under the provisions of section 443(b)(2). In such case, a return covering the 12-month period shall be attached to the return

for the short period as a part thereof, and the return and attachment will then be considered as an application for the benefits of section 443(b)(2).

(c) *Adjustment in deduction for personal exemption.* For adjustment in the deduction for personal exemptions in computing the tax for a short period resulting from a change of annual accounting period under section 443(b)(1) (or under section 441(f)(2)(B)(iii) in the case of certain changes from or to a 52-53-week taxable year), see paragraph (b)(1)(v) of this section.

(d) *Adjustments in exclusion of computing minimum tax for tax preferences.*

(1) If a return is made for a short period on account of any of the reasons specified in subsection (a) of section 443, the \$30,000 amount specified in section 56 (relating to minimum tax for tax preferences), modified as provided by section 58 and the regulations thereunder, shall be reduced to the amount which bears the same ratio to such specified amount as the number of days in the short period bears to 365.

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

*Example.* A taxpayer who is an unmarried individual has been granted permission under section 442 to change his annual accounting period files a return for the short period of 4 months ending April 30, 1970. The \$30,000 amount specified in section 56 is reduced as follows:

$$(120/365) \times \$30,000 = \$9,835.89.$$

(e) *Cross references.* For inapplicability of section 443(b) and paragraph (b) of this section in computing—

(1) Accumulated earnings tax, see section 536 and the regulations thereunder;

(2) Personal holding company tax, see section 546 and the regulations thereunder;

(3) Undistributed foreign personal holding company income, see section 557 and the regulations thereunder;

(4) The taxable income of a regulated investment company, see section 852(b)(2)(E) and the regulations thereunder; and

(5) The taxable income of a real estate investment trust, see section



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## § 1.444-1T

§ 1.444-3T *Manner and time of making section 444 election (temporary).*

- (a) In general.
- (b) Manner and time of making election.
  - (1) General rule.
  - (2) Special extension of time for making an election.
  - (3) Corporation electing to be an S corporation.
    - (i) In general.
    - (ii) Examples.
  - (4) Back-up section 444 election.
    - (i) General rule.
    - (ii) Procedures for making a back-up section 444 election.
    - (iii) Procedures for activating a back-up section 444 election.
      - (A) Partnership and S corporations.
        - (1) In general.
        - (2) Special rule if Form 720 used to satisfy return requirement.
      - (B) Personal service corporations.
        - (iv) Examples.
      - (c) Administrative relief.
        - (1) Extension of time to file income tax returns.
          - (i) Automatic extension.
          - (ii) Additional extensions.
          - (iii) Examples.
        - (2) No penalty for certain late payments.
          - (i) In general.
          - (ii) Example.
        - (d) Effective date.

[T.D. 8205, 53 FR 19693, May 27, 1988]

### § 1.444-1T Election to use a taxable year other than the required taxable year (temporary).

(a) *General rules*—(1) *Year other than required year.* Except as otherwise provided in this section and § 1.444-2T, a partnership, S corporation, or personal service corporation (as defined in § 1.441-3(c)) may make or continue an election (a “section 444 election”) to have a taxable year other than its required taxable year. See paragraph (b) of this section for limitations on the taxable year that may be elected. See § 1.444-2T for rules that generally prohibit a partnership, S corporation, or personal service corporation that is a member of a tiered structure from making or continuing a section 444 election. See § 1.444-3T for rules explaining how and when to make a section 444 election.

(2) *Effect of section 444 election*—(i) *In general.* A partnership or S corporation that makes or continues a section 444 election shall file returns and make payments as required by §§ 1.7519-1T

and 1.7519-2T. A personal service corporation that makes or continues a section 444 election is subject to the deduction limitation of § 1.280H-1T.

(ii) *Duration of section 444 election.* A section 444 election shall remain in effect until the election is terminated pursuant to paragraph (a)(5) of this section.

(3) *Section 444 election not required for certain years.* A partnership, S corporation, or personal service corporation is not required to make a section 444 election to use—

(i) A taxable year for which such entity establishes a business purpose to the satisfaction of the Commissioner (*i.e.*, approved under section 4 or 6 of Rev. Proc. 87-32, 1987-28 I.R.B. 14, or any successor revenue ruling or revenue procedure), or

(ii) A taxable year that is a “grandfathered fiscal year,” within the meaning of section 5.01(2) of Rev. Proc. 87-32 or any successor revenue ruling or revenue procedure.

Although a partnership, S corporation or personal service corporation qualifies to use a taxable year described in paragraph (a)(3) (i) or (ii) of this section, such entity may, if otherwise qualified, make a section 444 election to use a different taxable year. Thus, for example, assume that a personal service corporation that historically used a January 31 taxable year established to the satisfaction of the Commissioner, under section 6 of Rev. Proc. 87-32, a business purpose to use a September 30 taxable year for its taxable year beginning February 1, 1987. Pursuant to this paragraph (a)(3), such personal service corporation may use a September 30 taxable year without making a section 444 election. However, the corporation may, if otherwise qualified, make a section 444 election to use a year ending other than September 30 for its taxable year beginning February 1, 1987.

(4) *Required taxable year.* For purposes of this section, the term “required taxable year” means the taxable year determined under section 706(b), 1378, or 441(i) without taking into account any taxable year which is allowable either—

(i) By reason of business purpose (*i.e.*, approved under section 4 or 6 of Rev.

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Proc. 87-32 or any successor revenue ruling or procedure), or

(ii) As a “grandfathered fiscal year” within the meaning of section 5.01(2) of Rev. Proc. 87-32, or any successor revenue ruling or procedure.

(5) *Termination of section 444 election—*

(i) *In general.* A section 444 election is terminated when—

(A) A partnership, S corporation, or personal service corporation changes to its required taxable year; or

(B) A partnership, S corporation, or personal service corporation liquidates (including a deemed liquidation of a partnership under §1.708-1 (b)(1)(iv)); or

(C) A partnership, S corporation, or personal service corporation willfully fails to comply with the requirements of section 7519 or 280H, whichever is applicable; or

(D) A partnership, S corporation, or personal service corporation becomes a member of a tiered structure (within the meaning of §1.444-2T), unless it is a partnership or S corporation that meets the same taxable year exception under §1.444-2T (e); or

(E) An S corporation’s S election is terminated; or

(F) A personal service corporation ceases to be a personal service corporation.

However, if a personal service corporation, that has a section 444 election in effect, elects to be an S corporation, the S corporation may continue the section 444 election of the personal service corporation. Similarly, if an S corporation that has a section 444 election in effect terminates its S election and immediately becomes a personal service corporation, the personal service corporation may continue the section 444 election of the S corporation. If a section 444 election is terminated under this paragraph (a)(5), the partnership, S corporation, or personal service corporation may not make another section 444 election for any taxable year.

(ii) *Effective date of termination.* A termination of a section 444 election shall be effective—

(A) In the case of a change to the required year, on the first day of the short year caused by the change;

(B) In the case of a liquidating entity, on the date the liquidation is completed for tax purposes;

(C) In the case of willful failure to comply, on the first day of the taxable year (determined as if a section 444 election had never been made) determined in the discretion of the District Director;

(D) In the case of membership in a tiered structure, on the first day of the taxable year in which the entity is considered to be a member of a tiered structure, or such other taxable year determined in the discretion of the District Director;

(E) In the case of termination of S status, on the first day of the taxable year for which S status no longer exists;

(F) In the case of a personal service corporation that changes status, on the first day of the taxable year, for which the entity is no longer a personal service corporation.

In the case of a termination under this paragraph (a)(5) that results in a short taxable year, an income tax return is required for the short period. In order to allow the Service to process the affected income tax return in an efficient manner, a partnership, S corporation, or personal service corporation that files such a short period return should type or legibly print at the top of the first page of the income tax return for the short taxable year—“SECTION 444 ELECTION TERMINATED.” In addition, a personal service corporation that changes its taxable year to the required taxable year is required to annualize its income for the short period.

(iii) *Example.* The provisions of paragraph (a)(5)(ii) of this section may be illustrated by the following example.

*Example.* Assume a partnership that is 100 percent owned, at all times, by calendar year individuals has historically used a June 30 taxable year. Also assume the partnership makes a valid section 444 election to retain a year ending June 30 for its taxable year beginning July 1, 1987. However, for its taxable year beginning July 1, 1988, the partnership changes to a calendar year, its required year. Based on these facts, the partnership’s section 444 election is terminated on July 1, 1988, and the partnership must file a short period return for the period July 1, 1988-December 31, 1988. Furthermore, pursuant to

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§ 1.702-3T(a)(1), the partners in such partnership are not entitled to a 4-year spread with respect to partnership items of income and expense for the taxable year beginning July 1, 1988 and ending December 31, 1988.

(iv) *Special rule for entity that liquidates or is sold prior to making a section 444 election, required return, or required payment.* A partnership, S corporation, or personal service corporation that is liquidated or sold for tax purposes before a section 444 election, required return, or required payment is made for a particular year may, nevertheless, make or continue a section 444 election, if otherwise qualified. (See §§ 1.7519-2T (a)(2) and 1.7519-1T (a)(3), respectively, for a description of the required return and a definition of the term “required payment.”) However, the partnership, S corporation, or personal service corporation (or a trustee or agent thereof) must comply with the requirements for making or continuing a section 444 election. Thus, if applicable, required payments must be made and a subsequent claim for refund must be made in accordance with § 1.7519-2T(a)(6). The following examples illustrate the application of this paragraph (a)(5)(iv).

*Example 1.* Assume an existing S corporation historically used a June 30 taxable year and desires to make a section 444 election for its taxable year beginning July 1, 1987. Assume further that the S corporation is liquidated for tax purposes on February 15, 1988. If otherwise qualified, the S corporation (or a trustee or agent thereof) may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 15, 1988. However, if the S corporation makes a section 444 election, it must comply with the requirements for making a section 444 election, including making required payments.

*Example 2.* The facts are the same as in Example 1, except that instead of liquidating on February 15, 1988, the shareholders of the S corporation sell their stock to a corporation on February 15, 1988. Thus, the corporation's S election is terminated on February 15, 1988. If otherwise qualified, the corporation may make a section 444 election to have a taxable year beginning July 1, 1987, and ending February 14, 1988.

*Example 3.* The facts are the same as in Example 2, except that the new shareholders are individuals. Furthermore, the corporation's S election is not terminated. Based on these facts, the S corporation, if otherwise qualified, may make a section 444 election to retain a year ending June 30 for its taxable

year beginning July 1, 1987. Furthermore, the S corporation may, if otherwise qualified, continue its section 444 election for subsequent taxable years.

(6) *Re-activating certain S elections—(i) Certain corporations electing S status that did not make a back-up calendar year request.* If a corporation that timely filed Form 2553, Election by a Small Business Corporation, effective for its first taxable year beginning in 1987—

(A) Requested a fiscal year based on business purpose,

(B) Did not agree to use a calendar year in the event its business purpose request was denied, and

(C) Such business purpose request is denied or withdrawn,

such corporation may retroactively re-activate its S election by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(ii) *Certain corporations that revoked their S status.* If a corporation that used a fiscal year revoked its S election (pursuant to section 1362(d)(1)) for its first taxable year beginning in 1987, such corporation may retroactively re-activate its S election (*i.e.* rescind its revocation) by making a valid section 444 election for its first taxable year beginning in 1987 and complying with the procedures in paragraph (a)(6)(iii) of this section.

(iii) *Procedures for re-activating an S election.* A corporation re-activating its S election pursuant to paragraph (a)(6)(i) or (ii) of this section must—

(A) Obtain the consents of all shareholders who have owned stock in the corporation since the first day of the first taxable year of the corporation beginning after December 31, 1986,

(B) Include the following statement at the top of the first page of the corporation's Form 1120S for its first taxable year beginning in 1987—“SECTION 444 ELECTION—RE-ACTIVATES S STATUS,” and

(C) Include the following statement with Form 1120S—“RE-ACTIVATION CONSENTED TO BY ALL SHAREHOLDERS WHO HAVE OWNED STOCK AT ANY TIME SINCE THE FIRST DAY OF THE FIRST TAXABLE YEAR OF THIS CORPORATION BEGINNING AFTER DECEMBER 31, 1986.”

(iv) *Examples.* The provisions of this paragraph (a)(6) may be illustrated by the following examples.

*Example 1.* Assume a corporation historically used a June 30 taxable year and such corporation timely filed Form 2553, Election by a Small Business Corporation, to be effective for its taxable year beginning July 1, 1987. On its Form 2553, the corporation requested permission to retain its June 30 taxable year based on business purpose. However, the corporation did not agree to use a calendar year in the event its business purpose request was denied. On April 1, 1988, the Internal Revenue Service notified the corporation that its business purpose request was denied and therefore the corporation's S election was not effective. Pursuant to paragraph (a)(6)(i) of this section, the corporation may re-activate its S election by making a valid section 444 election and complying with the procedures in paragraph (a)(6)(iii) of this section.

*Example 2.* The facts are the same as in Example 1, except that as of July 26, 1988, the Internal Revenue Service has not yet determined whether the corporation has a valid business purpose to retain a June 30 taxable year. Based on these facts, the corporation may, if otherwise qualified, make a back-up section 444 election as provided in § 1.444-3T(b)(4). If the corporation's business purpose request is subsequently denied, the corporation should follow the procedures in § 1.444-3T(b)(4)(iii) for activating a back-up section 444 election rather than the procedures provided in this paragraph (a)(6) for re-activating an S election.

*Example 3.* Assume a corporation has historically been an S corporation with a March 31 taxable year. However, for its taxable year beginning April 1, 1987, the corporation revoked its S election pursuant to section 1362(d)(1). Pursuant to paragraph (a)(6)(ii) of this section, such corporation may retroactively rescind its S election revocation by making a valid section 444 election for its taxable year beginning April 1, 1987, and complying with the procedures provided in paragraph (a)(6)(iii) of this section. If the corporation retroactively rescinds its S revocation, the corporation shall file a Form 1120S for its taxable year beginning April 1, 1987.

(b) *Limitation on taxable years that may be elected—(1) General rule.* Except as provided in paragraphs (b)(2) and (3) of this section, a section 444 election may be made only if the deferral period (as defined in paragraph (b)(4) of this section) of the taxable year to be elected is not longer than three months.

(2) *Changes in taxable year—(i) In general.* In the case of a partnership, S corporation, or personal service corpora-

tion changing its taxable year, such entity may make a section 444 election only if the deferral period of the taxable year to be elected is not longer than the shorter of—

(A) Three months, or

(B) The deferral period of the taxable year that is being changed, as defined in paragraph (b)(2)(iii) of this section.

(ii) *Special rule for certain existing corporations electing S status.* If a corporation with a taxable year other than the calendar year—

(A) Elected after September 18, 1986, and before January 1, 1988, under section 1362 of the Code to be an S corporation, and

(B) Elected to have the calendar year as the taxable year of the S corporation,

then, for taxable years beginning before 1989, paragraph (b)(2)(i) of this section shall be applied by taking into account the deferral period of the last taxable year of the corporation prior to electing to be an S corporation, rather than the deferral period of the taxable year that is being changed. Thus, the provisions of the preceding sentence do not apply to a corporation that elected to be an S corporation for its first taxable year.

(iii) *Deferral period of the taxable year that is being changed.* For purposes of paragraph (b)(2)(i)(B) of this section, the phrase “deferral period of the taxable year that is being changed” means the deferral period of the taxable year immediately preceding the taxable year for which the taxpayer desires to make a section 444 election. Furthermore, the deferral period of such year will be determined by using the required taxable year of the taxable year for which the taxpayer desires to make a section 444 election. For example, assume P, a partnership that has historically used a March 31 taxable year, desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1987. Furthermore, assume that pursuant to paragraph (a)(4) of this section, P's required taxable year for the taxable year beginning April 1, 1987 is a year ending December 31. Based on these facts the deferral period of the taxable year being changed is nine

months (the period from March 31 to December 31).

(iv) *Examples.* See paragraph (d)(1) of this section for examples that illustrate the provisions of this paragraph (b)(2).

(3) *Special rule for entities retaining 1986 taxable year.* Notwithstanding paragraph (b)(2) of this section, a partnership, S corporation, or personal service corporation may, for its first taxable year beginning after December 31, 1986, if otherwise qualified, make a section 444 election to have a taxable year that is the same as the entity's last taxable year beginning in 1986. See paragraph (d)(2) of this section for examples that illustrate the provisions of this paragraph (b)(3).

(4) *Deferral period*—(i) *Retentions of taxable year.* For a partnership, S corporation, or personal service corporation that desires to retain its taxable year by making a section 444 election, the term “deferral period” means the months between the beginning of such year and the close of the first required taxable year (as defined in paragraph (a)(4) of this section). The following example illustrates the application of this paragraph (b)(4)(i).

*Example.* AB partnership has historically used a taxable year ending July 31. AB desires to retain its July 31 taxable year by making a section 444 election for its taxable year beginning August 1, 1987. Calendar year individuals, A and B, each own 50 percent of the profits and capital of AB; thus, under paragraph (a)(4) of this section AB's required taxable year is the year ending December 31. Pursuant to this paragraph (b)(4)(i), if AB desires to retain its year ending July 31, the deferral period is five months (the months between July 31 and December 31).

(ii) *Adoptions of and changes in taxable year*—(A) *In general.* For a partnership, S corporation, or personal service corporation that desires to adopt or change its taxable year by making a section 444 election, the term “deferral period” means the months that occur after the end of the taxable year desired under section 444 and before the close of the required taxable year.

(B) *Special rule.* If a partnership, S corporation or personal service corporation is using the required taxable year as its taxable year, the deferral period is deemed to be zero.

(C) *Examples.* The provisions of this paragraph (b)(4)(ii) may be illustrated by the following examples.

*Example 1.* Assume that CD partnership has historically used the calendar year and that CD's required taxable year is the calendar year. Under the special rule provided in paragraph (b)(4)(ii)(B) of this section, CD's deferral period is zero. See paragraph (b)(2)(i) of this section for rules that preclude CD from making a section 444 election to change its taxable year.

*Example 2.* E, a newly formed partnership, began operations on December 1, 1987, and is owned by calendar year individuals. E desires to make a section 444 election to adopt a September 30 taxable year. E's required taxable year is December 31. Pursuant to paragraph (b)(4)(ii)(A) of this section E's deferral period for the taxable year beginning December 1, 1987, is three months (the number of months between September 30 and December 31).

*Example 3.* Assume that F, a personal service corporation, has historically used a June 30 taxable year. F desires to make a section 444 election to change to an August 31 taxable year, effective for its taxable year beginning July 1, 1987. For purposes of determining the availability of a section 444 election for changing to the taxable year ending August 31, the deferral period of an August 31 taxable year is four months (the number of months between August 31 and December 31). The deferral period for F's existing June 30 taxable year is six months (the number of months between June 30 and December 31). Pursuant to § 1.444-1T(b)(2)(i), F may not make a section 444 election to change to an August 31 taxable year.

(5) *Miscellaneous rules*—(i) *Special rule for determining the taxable year of a corporation electing S status.* For purposes of this section, and only for purposes of this section, a corporation that elected to be an S corporation for a taxable year beginning in 1987 or 1988 and which elected to be an S corporation prior to September 26, 1988, will not be considered to have adopted or changed its taxable year by virtue of information included on Form 2553, Election by a Small Business Corporation. See Example 8 in paragraph (d) of this section.

(ii) *Special procedure for cases where an income tax return is superseded*—(A) *In general.* In the case of a partnership, S corporation, or personal service corporation that filed an income tax return for its first taxable year beginning

after December 31, 1986, but subsequently makes a section 444 election that would result in a different year end for such taxable year, the income tax return filed pursuant to the section 444 election will supersede the original return. However, any payments of income tax made with respect to such superseded return will be credited to the taxpayer's superseding return and the taxpayer may file a claim for refund for such payments. See examples (5) and (7) in paragraph (d)(2) of this section.

(B) *Procedure for superseding return.* In order to allow the Service to process the affected income tax returns in an efficient manner, a partnership, S corporation, or personal service corporation that desires to supersede an income tax return in accordance with paragraph (b)(5)(ii)(A) of this section, should type or legibly print at the top of the first page of the income tax return for the taxable year elected—“SECTION 444 ELECTION—SUPERSEDES PRIOR RETURN.”

(iii) *Anti-abuse rule*—If an existing partnership, S corporation or personal service corporation (“predecessor entities”), or the owners thereof, transfer assets to a related party and the principal purpose of such transfer is to—

(A) Create a deferral period greater than the deferral period of the predecessor entity's taxable year, or

(B) Make a section 444 election following the termination of the predecessor entity's section 444 election, then such transfer will be disregarded for purposes of section 444 and this section, even if the deferral created by such change is effectively eliminated by a required payment (within the meaning of section 7519) or deferral of a deduction (to a personal service corporation under section 280H). The following example illustrates the application of this paragraph (b)(5)(iii).

*Example.* Assume that P1 is a partnership that historically used the calendar year and is owned by calendar year partners. Assume that P1 desires to make a section 444 election to change to a September year for the taxable year beginning January 1, 1988. P1 may not make a section 444 election to change taxable years under section 444(b)(2) because its current deferral period is zero. Assume further that P1 transfers a substantial portion of its assets to a newly-formed

partnership (P2), which is owned by the partners of P1. Absent paragraph (b)(5)(iii) of this section, P2 could, if otherwise qualified, make a section 444 election under paragraph (b)(1) of this section to use a taxable year with a three month or less deferral period (*i.e.*, a September 30, October 31, or November 30 taxable year). However, if the principal purpose of the asset transfer was to create a one-, two-, or three-month deferral period by P2 making a section 444 election, the section 444 election shall not be given effect, even if the deferral would be effectively eliminated by P2 making a required payment under section 7519.

(iv) *Special rules for partial months and 52-53-week taxable years.* Except as otherwise provided in § 1.280H-1T(c)(2)(i)(A), for purposes of this section and §§ 1.7519-1T, 1.7519-2T and 1.280H-1T—

(A) A month of less than 16 days is disregarded, and a month of more than 15 days is treated as a full month; and

(B) A 52-53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(c) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

(d) *Examples*—(1) *Changes in taxable year.* The following examples illustrate the provisions of paragraph (b)(2) of this section.

*Example 1.* A is a personal service corporation that historically used a June 30 taxable year. A desires to make a section 444 election to change to an August 31 taxable year, effective with its taxable year beginning July 1, 1987. Under paragraph (b)(4)(ii) of this section, the deferred period of the taxable year to be elected is four months (the number of months between August 31 and December 31). Furthermore, the deferral period of the taxable year that is being changed is six months (the number of months between June 30 and December 31). Pursuant to paragraph (b)(2)(i) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferred period of the taxable year being changed. Since the deferral period of the taxable year to be elected (August 31) is greater than three months, A may not make a section 444 election to change to the taxable year ending August 31. However, since the deferral period of the taxable year that is being changed is three months or more, A may, if otherwise qualified, make a section

444 election to change to a year ending September 30, 1987 (three-month deferral period), a year ending October 31, 1987 (two-month deferral period), or a year ending November 30, 1987 (one-month deferral period). In addition, instead of making a section 444 election to change its taxable year, A could, if otherwise qualified, make a section 444 election to retain its June end, pursuant to paragraph (b)(3) of this section.

*Example 2.* B, a corporation that historically used an August 31 taxable year, elected on November 1, 1986 to be an S corporation for its taxable year beginning September 1, 1986. As a condition to having the S election accepted, B agreed on Form 2553 to use calendar year. Pursuant to the general effective date provided in paragraph (c) of this section, B may not make a section 444 election for its taxable year beginning in 1986. Thus, B must file a short period income tax return for the period September 1 to December 31, 1986.

*Example 3.* The facts are the same as in Example 2, except that B desires to make a section 444 election for its taxable year beginning January 1, 1987. Absent paragraph (b)(2)(ii) of this section, B would not be allowed to change its taxable year because the deferral period of the taxable year being changed (*i.e.*, the calendar year) is zero. However, pursuant to the special rule provided in paragraph (b)(2)(ii) of this section, B shall apply paragraph (b)(2)(i) of this section by taking into account the deferral period of the last taxable year of B prior to B's election to be an S corporation (four months), rather than the deferral period of B's taxable year that is being changed (zero months). Thus, if otherwise qualified, B may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30, for its taxable year beginning January 1, 1987.

*Example 4.* The facts are the same as in Example 3, except that B files a calendar year income tax return for 1987 rather than making a section 444 election. However, for its taxable year beginning January 1, 1988, B desires to change its taxable year by making a section 444 election. Given that the special rule provided in paragraph (b)(2)(ii) of this section applies to section 444 elections made in taxable years beginning before 1989, B may, if otherwise qualified, make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning January 1, 1988.

*Example 5.* C, a corporation that historically used a June 30 taxable year, elected on December 15, 1986 to be an S corporation for its taxable year beginning July 1, 1987. As a condition to having the S election accepted, C agreed on Form 2553 to use a calendar year. Although pursuant to paragraph (b)(3) of this section, C would, if otherwise quali-

fied, be allowed to retain its June 30 taxable year, C desires to change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (b)(2) of this section, a taxpayer may, if otherwise qualified, make a section 444 election to change to a taxable year only if the deferral period of the taxable year to be elected is not longer than the shorter of three months or the deferral period of the taxable year being changed. Given these facts, the deferral period of the taxable year to be elected is 3 months (September 30 to December 31) while the deferral period of the taxable year being changed is 6 months (June 30 to December 31). Thus, C may, if otherwise qualified, change to a September 30 taxable year for its taxable year beginning July 1, 1987, by making a section 444 election. The fact that C agreed on Form 2553 to use a calendar year is not relevant.

*Example 6.* D, a corporation that historically used a March 31 taxable year, elects on June 1, 1988 to be an S corporation for its taxable year beginning April 1, 1988. D desires to change to a June 30 taxable year by making a section 444 election for its taxable year beginning April 1, 1988. Pursuant to paragraph (b)(2)(i) of this section, D may not change to a June 30 taxable year because such year would have a deferral period greater than 3 months. However, if otherwise qualified, D may make a section 444 election to change to a taxable year ending September 30, October 31, or November 30 for its taxable year beginning April 1, 1988.

*Example 7.* E, a corporation that began operations on November 1, 1986, elected to be an S corporation on December 15, 1986, for its taxable year beginning November 1, 1986. E filed a short period income tax return for the period November 1 to December 31, 1986. E desires to change to a September 30 taxable year by making a section 444 election for its taxable year beginning January 1, 1987. Although E elected to be an S corporation after September 18, 1986, and before January 1, 1988, paragraph (b)(2)(ii) of this section does not apply to E since E was not a C corporation prior to electing S status. Thus, E may not change its taxable year for the taxable year beginning January 1, 1987, by making a section 444 election.

*Example 8.* The facts are the same as in Example 7, except that E began operations on April 15, 1987, and elected to be an S corporation on June 1, 1987, for its taxable year beginning April 15, 1987. As a condition to being an S corporation, E agreed on Form 2553 to use a calendar year. E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987. Pursuant to paragraph (b)(5)(i) of this section, E's agreement to use a calendar year on Form 2553 does not mean that E has adopted a calendar year. Thus, E's desire to make a section 444 election to use a

September 30 taxable year will not be considered a change in taxable year and thus paragraph (b)(2) of this section will not apply. Instead, E will be subject to paragraph (b)(1) of this section. Since a September 30 taxable year would result in only a three-month deferral period (September 30 to December 31), E may, if otherwise qualified, make a section 444 election to use a year ending September 30 for its taxable year beginning April 15, 1987.

(2) *Special rule for entities retaining their 1986 taxable year.* The following examples illustrate the provisions of paragraph (b)(3) of this section.

*Example 1.* F, an S corporation that elected to be an S corporation several years ago, has historically used a June 30 taxable year. F desires to retain its June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Pursuant to paragraph (b)(4)(i) of this section, the deferral period of the taxable year being retained is 6 months (June 30 to December 31, F's required taxable year). Absent the special rule provided in paragraph (b)(3) of this section, F would be subject to the general rule provided in paragraph (b)(1) of this section which limits the deferral period of the taxable year elected to three months or less. However, pursuant to paragraph (b)(3) of this section, F may, if otherwise qualified, make a section 444 election to retain its year ending June 30 for its taxable year beginning July 1, 1987.

*Example 2.* The facts are the same as in Example 1, except that F received permission from the Commissioner to change its taxable year to the calendar year, and filed a short period income tax return for the period July 1 to December 31, 1986. F desires to make a section 444 election to use a year ending June 30 for its taxable year beginning January 1, 1987. Given that F had a December 31 taxable year for its last taxable year beginning in 1986, the special rule provided in paragraph (b)(3) of this section does not allow F to use a June 30 taxable year for its taxable year beginning January 1, 1987. Furthermore, pursuant to paragraph (b)(2)(i) of this section, F is not allowed to change its taxable year from December 31 to June 30 because the deferral period of the taxable year being changed is zero months.

*Example 3.* G, a corporation that historically used an August 31 taxable year, elected to be an S corporation on November 15, 1986, for its taxable year beginning September 1, 1986. As a condition to obtaining S status, G agreed to use a calendar year. Thus, G filed its first S corporation return for the period September 1 to December 31, 1986. G desires to make a section 444 election to use a year ending August 31 for its taxable year beginning January 1, 1987. Since G's last taxable year beginning in 1986 was a calendar year, G

cannot use paragraph (b)(3) of this section, relating to retentions of taxable years, to elect an August 31 taxable year. Thus, G is subject to paragraph (b)(2)(i) of this section, relating to changes in taxable year. Although G, if otherwise qualified, may use the special rule provided in paragraph (b)(2)(ii) of this section, G may only change from its current taxable year (*i.e.*, the calendar year) to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30).

*Example 4.* The facts are the same as in Example 3, except that G elected to be an S corporation for its taxable year beginning September 1, 1987, rather than its taxable year beginning September 1, 1986. As a condition to making its S election, G agreed, on Form 2553, to use the calendar year. However, G has not yet filed a short period income tax return for the period September 1 to December 31, 1987. Given these facts, paragraph (b)(3) of this section would allow G, if otherwise qualified, to make a section 444 election to retain an August 31 taxable year for its taxable year beginning September 1, 1987.

*Example 5.* The facts are the same as in Example 4, except that G has already filed a short period income tax return for the period September 1 to December 31, 1987. Pursuant to paragraph (b)(5)(ii)(A) of this section, G may supersede the return it filed for the period September 1 to December 31, 1987. Thus, pursuant to paragraph (b)(3) of this section, G may, if otherwise qualified, make a section 444 election to retain an August 31 taxable year for the taxable year beginning September 1, 1987. In addition, G should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

*Example 6.* H, a corporation that historically used a May 31 taxable year, elects to be an S corporation on June 15, 1988 for its taxable year beginning June 1, 1988. H desires to make a section 444 election to use a taxable year other than the calendar year. Since the taxable year in issue is not H's first taxable year beginning after December 31, 1986, H may not use the special rule provided in paragraph (b)(3)(i) and thus may not retain its May 31 year. However, H may, if otherwise qualified, make a section 444 election under paragraph (b)(2)(i) of this section, to change to a taxable year that has no more than a three-month deferral period (*i.e.*, September 30, October 31, or November 30) for its taxable year beginning June 1, 1988.

*Example 7.* I is a partnership that has historically used a calendar year. Sixty percent of the profits and capital of I are owned by Q, a corporation (that is neither an S corporation nor a personal service corporation) that has a June 30 taxable year, and 40 percent of the profits and capital are owned by

R, a calendar year individual. Since the partner that has more than a fifty percent interest in I has a June 30 taxable year, I's required taxable year is June 30. Accordingly, I filed an income tax return for the period January 1 to June 30, 1987. Based on these facts, I may, pursuant to paragraph (b)(5)(ii)(A) of this section, disregard the income tax return filed for the period January 1 to June 30, 1987. Thus, if otherwise qualified, I may make a section 444 election under paragraph (b)(2)(i) of this section to use a calendar year for its taxable year beginning January 1, 1987. If I makes such a section 444 election, I should follow the special procedures set forth in paragraph (b)(5)(ii)(B) of this section.

[T.D. 8205, 53 FR 19694, May 27, 1988, as amended by T.D. 8996, 67 FR 35012, May 17, 2002]

**§ 1.444-2T Tiered structure (temporary).**

(a) *General rule.* Except as provided in paragraph (e) of this section, no section 444 election shall be made or continued with respect to a partnership, S corporation, or personal service corporation that is a member of a tiered structure on the date specified in paragraph (d) of this section. For purposes of this section, the term "personal service corporation" means a personal service corporation as defined in § 1.441-3(c).

(b) *Definition of a member of a tiered structure—(1) In general.* A partnership, S corporation, or personal service corporation is considered a member of a tiered structure if—

(i) The partnership, S corporation, or personal service corporation directly owns any portion of a deferral entity, or

(ii) A deferral entity directly owns any portion of the partnership, S corporation, or personal service corporation.

However, see paragraph (c) of this section for certain de minimis rules, and see paragraph (b)(3) of this section for an anti-abuse rule. In addition, for purposes of this section, a beneficiary of a trust shall be considered to own an interest in the trust.

(2) *Deferral entity—(i) In general.* For purposes of this section, the term "deferral entity" means an entity that is a partnership, S corporation, personal service corporation, or trust. In the case of an affiliated group of corporations filing a consolidated income tax

return that is treated as a personal service corporation pursuant to § 1.441-4T (i), such affiliated group is considered to be a single deferral entity.

(ii) *Grantor trusts.* The term "deferral entity" does not include a trust (or a portion of a trust) which is treated as owned by the grantor or beneficiary under Subpart E, part I, subchapter J, chapter 1, of the Code (relating to grantor trusts), including a trust that is treated as a grantor trust pursuant to section 1361(d)(1)(A) of the Code (relating to qualified subchapter S trusts). Thus, any taxpayer treated under subpart E as owning a portion of a trust shall be treated as owning the assets of the trust attributable to that ownership. The following examples illustrate the provisions of this paragraph (b)(2)(ii).

*Example 1.* A, an individual, is the sole beneficiary of T. T is a trust that owns 50 percent of the profits and capital of X, a partnership that desires to make a section 444 election. Furthermore, pursuant to Subpart E, Part I, subchapter J, chapter 1 of the Code, A is treated as an owner of X. Based upon these facts, T is not a deferral entity and 50 percent of X is considered to be directly owned by A.

*Example 2.* The facts are the same as in Example 1, except that A is a personal service corporation rather than an individual. Given these facts, 50 percent of X is considered to be directly owned by A, a deferral entity. Thus, X is considered to be a member of a tiered structure.

(3) *Anti-abuse rule.* Notwithstanding paragraph (b)(1) of this section, a partnership, S corporation, or personal service corporation is considered a member of a tiered structure if the partnership, S corporation, personal service corporation, or related taxpayers have organized or reorganized their ownership structure or operations for the principal purpose of obtaining a significant unintended tax benefit from making or continuing a section 444 election. For purposes of the preceding sentence, a significant unintended tax benefit results when a partnership, S corporation, or personal service corporation makes a section 444 election and, as a result, a taxpayer (not limited to the entity making the election) obtains a significant deferral of income

substantially all of which is not eliminated by a required payment under section 7519. See examples (15) through (19) in paragraph (f) of this section.

(c) *De minimis rules*—(1) *In general.* For rules relating to a de minimis exception to paragraph (b)(1)(i) of this section (the “downstream de minimis rule”), see paragraph (c)(2) of this section. For rules relating to a de minimis exception to paragraph (b)(1)(ii) of this section (the “upstream de minimis rule”), see paragraph (c)(3) of this section. For rules relating to the interaction of the de minimis rules provided in this paragraph (c) and the “same taxable year exception” provided in paragraph (e) of this section, see paragraph (e)(5) of this section.

(2) *Downstream de minimis rule*—(i) *General rule.* If a partnership, S corporation, or personal service corporation directly owns any portion of one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(i) of this section if, in the aggregate, all such deferral entities accounted for—

(A) Not more than 5 percent of the partnership’s, S corporation’s, or personal service corporation’s adjusted taxable income for the testing period (“5 percent adjusted taxable income test”), or

(B) Not more than 2 percent of the partnership’s, S corporation’s, or personal service corporation’s gross income for the testing period (“2 percent gross income test”). See section 702 (c) for rules relating to the determination of gross income of a partner in a partnership.

See examples (3) through (5) in paragraph (f) of this section.

(ii) *Definition of testing period.* For purposes of this paragraph (c)(2), the term “testing period” means the taxable year that ends immediately prior to the taxable year for which the partnership, S corporation, or personal service corporation desires to make or continue a section 444 election. However, see the special rules provided in paragraph (c)(2)(iv) of this section for certain special cases (e.g., the partnership, S corporation, personal service corporation or deferral entity was not in existence during the entire testing

period). The following example illustrates the application of this paragraph (c)(2)(ii).

*Example.* A partnership desires to make a section 444 election for its taxable year beginning November 1, 1987. The testing period for purposes of determining whether deferral entities owned by such partnership are de minimis under paragraph (c)(2) of this section is the taxable year ending October 31, 1987. If either the partnership or the deferral entities were not in existence for the entire taxable year ending October 1, 1987, see the special rules provided in paragraph (c)(2)(iv) of this section.

(iii) *Definition of adjusted taxable income*—(A) *Partnership.* In the case of a partnership, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Aggregate amount of the partnership items described in section 702(a) (other than credits and tax-exempt income),

(2) Applicable payments defined in section 7519(d)(3) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(1) of this section, and

(3) Guaranteed payments defined in section 707(c) that are deducted in determining the amount described in paragraph (c)(2)(iii)(A)(1) of this section and are not otherwise included in paragraph (c)(2)(iii)(A)(2) of this section. For purposes of determining the aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(1) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 702(a) a partnership has \$1,000 of ordinary taxable income, \$500 of specially allocated deductions, and \$300 of capital loss, the partnership’s aggregate amount of partnership items under paragraph (c)(2)(iii)(A)(1) of this section is \$200 (\$1,000-\$500-\$300).

(B) *S corporation.* In the case of an S corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Aggregate amount of the S corporation items described in section 1366(a) (other than credits and tax-exempt income), and

(2) Applicable payments defined in section 7519(d)(3) that are deducted in

determining the amount described in paragraph (c)(2)(iii)(B)(I) of this section.

For purposes of determining the aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(I) of this section, deductions and losses are treated as negative income. Thus, for example, if under section 1366(a) an S corporation has \$2,000 of ordinary taxable income, \$1,000 of deductions described in section 1366(a)(1)(A) of the Code, and \$500 of capital loss, the S corporation's aggregate amount of S corporation items under paragraph (c)(2)(iii)(B)(I) of this section is \$500 (\$2,000-\$1,000-\$500).

(C) *Personal service corporation.* In the case of a personal service corporation, adjusted taxable income for purposes of paragraph (c)(2) of this section is an amount equal to the sum of the—

(1) Taxable income of the personal service corporation, and

(2) Applicable amounts defined in section 280H(f)(1) that are deducted in determining the amount described in paragraph (c)(2)(iii)(C)(I) of this section.

(iv) *Special rules—(A) Pro-forma rule.* Except as provided in paragraph (c)(iv)(C)(2) of this section, if a partnership, S corporation, or personal service corporation directly owns any interest in a deferral entity as of the date specified in paragraph (d) of this section and such ownership interest is different in amount from the partnership's, S corporation's, or personal service corporation's interest on any day during the testing period, the 5 percent adjusted taxable income test and the 2 percent gross income test must be applied on a pro-forma basis (*i.e.*, adjusted taxable income and gross income must be calculated for the testing period assuming that the partnership, S corporation, or personal service corporation owned the same interest in the deferral entity that it owned as of the date specified in paragraph (d) of this section). The following example illustrates the application of this paragraph (c)(2)(iv)(A).

*Example.* A personal service corporation desiring to make a section 444 election for its taxable year beginning October 1, 1987, acquires a 25 percent ownership interest in a partnership on or after October 1, 1987. Furthermore, the partnership has been in exist-

ence for several years. The personal service corporation must modify its calculations of the 5 percent adjusted taxable income test and the 2 percent gross income test for the testing period ended September 30, 1987, by assuming that the personal service corporation owned 25 percent of the partnership during such testing period and the personal service corporation's adjusted taxable income and gross income were correspondingly adjusted.

(B) *Reasonable estimates allowed.* If the information necessary to complete the pro-forma calculation described in paragraph (c)(2)(iv)(A) of this section is not readily available, the partnership, S corporation, or personal service corporation may make a reasonable estimate of such information.

(C) *Newly formed entities—(1) Newly formed deferral entities.* If a partnership, S corporation, or personal service corporation owns any portion of a deferral entity on the date specified in paragraph (d) of this section and such deferral entity was not in existence during the entire testing period (hereinafter referred to as a "newly formed deferral entity"), both the 5 percent adjusted taxable income test and the 2 percent gross income test are modified as follows. First, the partnership, S corporation, or personal service corporation shall calculate the percentage of its adjusted taxable income or gross income that is attributable to deferral entities, excluding newly formed deferral entities. Second, the partnership, S corporation, or personal service corporation shall calculate (on the date specified in paragraph (d) of this section) the percentage of the tax basis of its assets that are attributable to its tax basis with respect to its ownership interests in all newly formed deferral entities. If the sum of the two percentages is 5 percent or less, the deferral entities are considered de minimis and are disregarded for purposes of paragraph (b)(1)(i) of this section. If the sum of the two percentages is greater than 5 percent, the deferral entities do not qualify for the de minimis rule provided in paragraph (c)(2) of this section and thus the partnership, S corporation, or personal service corporation is considered to be a member of a tiered structure for purposes of this section.

(2) *Newly formed partnership, S corporation, or personal service corporation*

*desiring to make a section 444 election.* If a partnership, S corporation, or personal service corporation desires to make a section 444 election for the first taxable year of its existence, the 5 percent adjusted taxable income test and the 2 percent gross income test are replaced by a 5 percent of assets test. Thus, if on the date specified in paragraph (d) of this section, 5 percent or less of the assets (measured by reference to the tax basis of the assets) of the newly formed partnership, S corporation, or personal service corporation are attributable to the tax basis with respect to its ownership interests in the deferral entities, the deferral entities will be considered de minimis and will be disregarded for purposes of paragraph (b)(1)(i) of this section.

(3) *Upstream de minimis rule.* If a partnership, S corporation, or personal service corporation is directly owned by one or more deferral entities as of the date specified in paragraph (d) of this section, such ownership is disregarded for purposes of paragraph (b)(1)(ii) of this section if on the date specified in paragraph (d) of this section the deferral entities directly own, in the aggregate, 5 percent or less of—

(i) An interest in the current profits of the partnership, or

(ii) The stock (measured by value) of the S corporation or personal service corporation.

See examples (6) and (7) in paragraph (f) of this section.

(d) *Date for determining the existence of a tiered structure—(1) General rule.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will be considered a member of a tiered structure for a particular taxable year if the partnership, S corporation, or personal service corporation is a member of a tiered structure on the last day of the required taxable year (as defined in section 444 (e) of the Code) ending within such year. If a particular taxable year does not include the last day of the required taxable year for such year, the partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for such year. The following examples illustrate the application of this paragraph (d)(1).

*Example 1.* Assume that a newly formed partnership whose first taxable year begins November 1, 1988, desires to adopt a September 30 taxable year by making a section 444 election. Furthermore, assume that for its taxable year beginning November 1, 1988, the partnership's required taxable year is December 31. If the partnership is a member of a tiered structure on December 31, 1988, it will not be eligible to make a section 444 election for a taxable year beginning November 1, 1988, and ending September 30, 1989.

*Example 2.* Assume an S corporation that historically used a June 30 taxable year desires to make a section 444 election to change to a year ending September 30 for its taxable year beginning July 1, 1987. If the S corporation can make the section 444 election, it will have a short taxable year beginning July 1, 1987, and ending September 30, 1987. Given these facts, the short taxable year beginning July 1, 1987, does not include the last day of the S corporation's required taxable year for such year (i.e., December 31, 1987). Thus, pursuant to paragraph (d)(1) of this section, the S corporation will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987, and ending September 30, 1987.

(2) *Special rule for taxable years beginning in 1987.* For purposes of paragraph (a) of this section, a partnership, S corporation, or personal service corporation will not be considered a member of a tiered structure for a taxable year beginning in 1987 if the partnership, S corporation, or personal service corporation is not a member of a tiered structure on the day the partnership, S corporation, or personal service corporation timely files its section 444 election for such year. The following examples illustrate the application of this paragraph (d)(2).

*Example 1.* Assume that a partnership desires to retain a June 30 taxable year by making a section 444 election for its taxable year beginning July 1, 1987. Furthermore, assume that the partnership's required taxable year for such year is December 31 and that the partnership was a member of a tiered structure on such date. Also assume that the partnership was not a member of a tiered structure as of the date it timely filed its section 444 election for its taxable year beginning July 1, 1987. Based upon the special rule provided in this paragraph (d)(2), the partnership will not be considered a member of a tiered structure for its taxable year beginning July 1, 1987.

*Example 2.* Assume the same facts as in Example 1, except that the partnership was a member of a tiered structure on the date it filed its section 444 election for its taxable

year beginning July 1, 1987, but was not a member of a tiered structure on December 31, 1987. Paragraph (d)(1) of this section would still apply and thus the partnership would not be considered part of a tiered structure for its taxable year beginning July 1, 1987. However, the partnership would be considered a member of a tiered structure for its taxable year beginning July 1, 1988, if the partnership was a member of a tiered structure on December 31, 1988.

(e) *Same taxable year exception*—(1) *In general.* Although a partnership or S corporation is a member of a tiered structure as of the date specified in paragraph (d) of this section, the partnership, S corporation may make or continue a section 444 election if the tiered structure (as defined in paragraph (e)(2) of this section) consists entirely of partnerships or S corporations (or both), all of which have the same taxable year as determined under paragraph (e)(3) of this section. However, see paragraph (e)(5) of this section for the interaction of the de minimis rules provided in paragraph (c) of this section with the same taxable year exception. For purposes of this paragraph (e), two or more entities are considered to have the same taxable year if their taxable years end on the same day, even though they begin on different days. See examples (8) through (14) in paragraph (f) of this section.

(2) *Definition of tiered structure*—(i) *General rule.* For purposes of the same taxable year exception, the members of a tiered structure are defined to include the following entities—

(A) The partnership or S corporation that desires to qualify for the same taxable year exception,

(B) A deferral entity (or entities) directly owned (in whole or in part) by the partnership or S corporation that desires to qualify for the same taxable year exception,

(C) A deferral entity (or entities) directly owning any portion of the partnership or S corporation that desires to qualify for the same taxable year exception, and

(D) A deferral entity (or entities) directly owned (in whole or in part) by a “downstream controlled partnership,” as defined in paragraph (e)(2)(ii) of this section.

(ii) *Special flow-through rule for downstream controlled partnerships.* If more

than 50 percent of a partnership’s profits and capital are owned by a partnership or S corporation that desires to qualify for the same taxable year exception, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section. Furthermore, if more than 50 percent of a partnership’s profits and capital are owned by a downstream controlled partnership, such owned partnership is considered a downstream controlled partnership for purposes of paragraph (e)(2)(i) of this section.

(3) *Determining the taxable year of a partnership or S corporation.* The taxable year of a partnership or S corporation to be taken into account for purposes of paragraph (e)(1) of this section is the taxable year ending with or prior to the date specified in paragraph (d) of this section. Furthermore, the determination of such taxable year will take into consideration any section 444 elections made by the partnership or S corporation. See examples (10) and (11) in paragraph (f) of this section.

(4) *Special rule for 52-53-week taxable years.* For purposes of this paragraph (e), a 52-53-week taxable year with reference to the end of a particular month will be considered to be the same as a taxable year ending with reference to the last day of such month.

(5) *Interaction with de minimis rules*—(i) *Downstream de minimis rule*—(A) *In general.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and directly owns any member (or members) of the tiered structure with a taxable year different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the aggregate, the de minimis rule of paragraph (c)(2) of this section is satisfied with respect to such owned member (or members). The following example illustrates the application of this paragraph (e)(5)(i)(A).

*Example.* P, a partnership with a June 30 taxable year, owns 60 percent of P1, another partnership with a June 30 taxable year. P also owns 1 percent of P2 and P3, calendar

year partnerships. If, in the aggregate, P's ownership interests in P2 and P3 are considered de minimis under paragraph (c)(2) of this section, P meets the same taxable year exception and may make a section 444 election to retain its June 30 taxable year.

(B) *Special rule for members of a tiered structure directly owned by a downstream controlled partnership.* For purposes of paragraph (e)(5)(i)(A) of this section, a partnership or S corporation desiring to make or continue a section 444 election is considered to directly own any member of the tiered structure (as defined in paragraph (e)(2) of this section) directly owned by a downstream controlled partnership (as defined in paragraph (e)(2)(ii) of this section). The adjusted taxable income or gross income of the partnership or S corporation that is attributable to a member of a tiered structure directly owned by a downstream controlled partnership equals the adjusted taxable income or gross income of such member multiplied by the partnership's or S corporation's indirect ownership percentage of such member. The following example illustrates the application of this paragraph (e)(5)(i)(B).

*Example.* P, a partnership, desires to retain its June 30 taxable year by making a section 444 election. However, as of the date specified in paragraph (d) of this section, P owns 75 percent of P1, a June 30 partnership, and P1 owns 40 percent of P2, a calendar year partnership. P also owns 25 percent of P3, a calendar year partnership. Pursuant to paragraphs (e)(5)(i)(A) and (B) of this section, P may only qualify to use the same taxable year exception if, in the aggregate, P2 and P3 are de minimis with respect to P. Pursuant to paragraph (e)(5)(i)(B) of this section, P's adjusted taxable income or gross income attributable to P2 equals 30 percent (75 percent times 40 percent) of P2's adjusted taxable income or gross income.

(ii) *Upstream de minimis rule.* If a partnership or S corporation that desires to make or continue a section 444 election is a member of a tiered structure (as defined in paragraph (e)(2) of this section) and is owned directly by a member (or members) of the tiered structure with taxable years different from the taxable year of the partnership or S corporation, such ownership is disregarded for purposes of the same taxable year exception of paragraph (e)(1) of this section provided that, in the ag-

gregate, the de minimis rule of paragraph (c)(3) of this section is satisfied with respect to such owning member (or members). See Example 12 of paragraph (f) of this section.

(f) *Examples.* The provisions of this section may be illustrated by the following examples.

*Example 1.* A, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, A is owned by a combination of individuals and S corporations. The S corporations are deferral entities, as defined in paragraph (b)(2) of this section. Thus, pursuant to paragraph (b)(1)(ii) of this section, A will be a member of a tiered structure unless under paragraph (c)(3) of this section, the S corporations, in the aggregate, own a de minimis portion of A. If the S corporations' ownership in A is not considered de minimis under paragraph (c)(3) of this section, A is a member of a tiered structure and will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

*Example 2.* B, a partnership, desires to make or continue a section 444 election. However, on the date specified in paragraph (d) of this section, B is a partner in two partnerships, B1 and B2. B1 and B2 are deferral entities, as defined in paragraph (b)(2) of this section. Thus, under paragraph (b)(1)(i) of this section, B will be a member of a tiered structure unless B's aggregate ownership interests in B1 and B2 are considered de minimis under paragraph (c)(2) of this section. If B is a member of a tiered structure on the date specified in paragraph (d) of this section, B will be allowed to make or continue a section 444 election only if it meets the same taxable year exception provided in paragraph (e) of this section.

*Example 3.* C, a partnership with a September 30 taxable year, is 100 percent owned by calendar year individuals. C desires to make a section 444 election for its taxable year beginning October 1, 1987. However, on the date specified in paragraph (d) of this section, C owns a 1 percent interest in C1, a partnership. C does not own any other interest in a deferral entity. For the taxable year ended September 30, 1987, 10 percent of C's adjusted taxable income (as defined in paragraph (c)(2)(iii) of this section) was attributable to C's partnership interest in C1. Furthermore, 4 percent of C's gross income for the taxable year ended September 30, 1987, was attributable to C's partnership interest in C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is not de minimis because during the testing period more than 5 percent of C's adjusted taxable income is attributable to C1 and more than 2 percent

of C's gross income is attributable to C1. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

*Example 4.* The facts are the same as Example 3, except that for the taxable year ended September 30, 1987, only 2 percent of C's adjusted taxable income was attributable to C1. Under paragraph (c)(2) of this section, C's partnership interest in C1 is considered de minimis for purposes of determining whether C is a member of a tiered structure because not more than 5 percent of C's adjusted taxable income during the testing period is attributable to C1. Thus, C is not a member of a tiered structure for its taxable year beginning October 1, 1987.

*Example 5.* The facts are the same as Example 4, except that in addition to owning C1, C also owns 15 percent of C2, another partnership. For the taxable year ended September 30, 1987, 2 percent of C's adjusted taxable income is attributable to C1 and an additional 4 percent is attributable to C2. Furthermore, for the taxable year ended September 30, 1987, 4 percent of C's gross income is attributable to C1 while 3 percent is attributable to C2. Under paragraph (c)(2) of this section, C1 and C2 must be aggregated for purposes of determining whether C meets either the 5 percent adjusted taxable income test or the 2 percent gross income test. Since C's adjusted taxable income attributable to C1 and C2 is 6 percent (2 percent + 4 percent) and C's gross income attributable to C1 and C2 is 7 percent (4 percent + 3 percent), C does not meet the downstream de minimis rule provided in paragraph (c)(2) of this section. Thus, C is a member of a tiered structure for its taxable year beginning October 1, 1987.

*Example 6.* The facts are the same as Example 3, except that instead of determining whether C is part of a tiered structure, the issue is whether C1 is part of a tiered structure. In addition, assume that on the date specified in paragraph (d) of this section, the remaining 99 percent of C1 is owned by calendar year individuals and C1 does not own an interest in any deferral entity. Although C in Example 3 was considered to be a part of a tiered structure by virtue of its ownership interest in C1, C1 must be tested separately to determine whether it is part of a tiered structure. Since C's interest in C1 is 5 percent or less, C's interest in C1 is de minimis with respect to C1. See paragraph (c)(3) of this section. Thus, based upon these facts, C1 is not part of a tiered structure.

*Example 7.* The facts are the same as Example 6, except that the remaining 99 percent of C1 is owned 94 percent by calendar year individuals and 5 percent by C3, another partnership. Thus, deferral entities own 6 percent of C1 (1 percent owned by C and 5 percent owned by C3). Under paragraph (c)(3) of this section, deferral entities own more than a de minimis interest (i.e., 5 percent) of C1, and thus C1 is part of a tiered structure.

*Example 8.* D, a partnership with a September 30 taxable year, desires to make a section 444 election for its taxable year beginning October 1, 1987. On December 31, 1987, and the date D plans to file its section 444 election, D is 10 percent owned by D1, a personal service corporation with a September 30 taxable year, and 90 percent owned by calendar year individuals. Furthermore, D1 will retain its September 30 taxable year because it previously established a business purpose for such year. Since D is owned in part by D1, a personal service corporation, and the ownership interest is not de minimis under paragraph (c)(3) of this section, D is considered a member of a tiered structure for its taxable year beginning October 1, 1987. Furthermore, although D and D1 have the same taxable year, D does not qualify for the same taxable year exception provided in paragraph (e) of this section because D1 is a personal service corporation rather than a partnership or S corporation. Thus, pursuant to paragraph (a) of this section, D may not make a section 444 election for its taxable year beginning October 1, 1987.

*Example 9.* The facts are the same as Example 8, except that D1 is a partnership rather than a personal service corporation. Based upon these facts, D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, D may make a section 444 election for its taxable year beginning October 1, 1987.

*Example 10.* The facts are the same as Example 9, except that D1 has not established a business purpose for a September 30 taxable year. In addition, D1 does not desire to make a section 444 election and, under section 706(b), D1 will be required to change to a calendar year for its taxable year beginning October 1, 1987. Pursuant to paragraph (e)(3) of this section, D and D1 do not have the same taxable year for purposes of the same taxable year exception provided in paragraph (e) of this section. Thus, D may not make a section 444 election for its taxable year beginning October 1, 1987.

*Example 11.* The facts are the same as Example 8, except that D1 is a partnership with a March 31 taxable year. Furthermore, for its taxable year beginning April 1, 1987, D1 will change to a September 30 taxable year by making a section 444 election. Pursuant to paragraph (e)(3) of this section, D1 is considered to have a September 30 taxable year for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

*Example 12.* The facts are the same as Example 11, except that instead of the remaining 90 percent of D being owned by calendar

year individuals, it is owned 86 percent by individuals and 4 percent by D2, a calendar year partnership. Thus, D, a September 30 partnership, is 10 percent owned by D1, a September 30 partnership, 86 percent owned by calendar year individuals, and 4 percent owned by D2, a calendar year partnership. Under paragraph (e)(5)(ii) of this section, D2's ownership interest in D is considered de minimis for purposes of the same taxable year exception. Since D2's ownership interest in D is considered de minimis, it is disregarded for purposes of determining whether D qualifies for the same taxable year exception provided in paragraph (e) of this section. Thus, since both D and D1 will have the same taxable year as of the date specified in paragraph (d) of this section, D may make a section 444 election for its taxable year beginning October 1, 1987.

*Example 13.* E, a partnership with a June 30 taxable year, desires to make a section 444 election for its taxable year beginning July 1, 1987. On the date specified in paragraph (d) of this section, E is 100 percent owned by calendar year individuals; E owns 99 percent of the profits and capital of E1, a partnership with a June 30 taxable year; and E1 owns 30 percent of the profits and capital of E2, a partnership with a September 30 taxable year. E owns no other deferral entities. Pursuant to paragraph (b)(1)(i) of this section, E is considered to be a member of a tiered structure. Furthermore, pursuant to paragraph (e) of this section, E does not qualify for the same taxable year exception because E2 does not have the same taxable year as E and E1.

*Example 14.* The facts are the same as Example 13, except that E owns only 49 percent (rather than 99 percent) of the profits and capital of E1. Pursuant to paragraph (e) of this section, E qualifies for the same taxable year exception because E and E1 have the same taxable year. Pursuant to paragraph (e) of this section, E1's ownership interest in E2 is disregarded since E does not own more than 50 percent of E1's profits and capital.

*Example 15.* Prior to consideration of the anti-abuse rule provided in paragraph (b)(3) of this section, H, a partnership that commenced operations on October 1, 1987, is eligible to make a section 444 election for its taxable year beginning October 1, 1987. Although H may obtain a significant deferral of income substantially all of which is not eliminated by a required payment under section 7519 (since there will be no required payment for H's first taxable year), the anti-abuse rule of paragraph (b)(3) will not apply unless the principal purpose of organizing H was the attainment of a significant deferral of income that would result from making a section 444 election.

*Example 16.* F, a partnership with a January 31 taxable year, desires to make a section 444 election to retain its January 31 tax-

able year for the taxable year beginning February 1, 1987. F is 100 percent owned by calendar year individuals. Prior to the date specified in paragraph (d) of this section, F contributes substantially all of its assets to F1, a partnership, in exchange for a 51 percent interest in F1. The remaining 49 percent of F1 is owned by the calendar year individuals owning 100 percent of F. If F is allowed to make a section 444 election to retain its January 31 taxable year, F1's required taxable year will be January 31 since a majority of F1's partners use a January 31 taxable year (see § 1.706-3T). F's principal purpose for creating F1 and contributing its assets to F1 is to obtain an 11-month deferral on 49 percent of the income previously earned by F and now earned by F1. Pursuant to paragraph (b)(3) of this section, F is not allowed to make a section 444 election for its taxable year beginning February 1, 1987.

*Example 17.* The facts are the same as in Example 16, except that F does not create F1 and contribute its assets to F1 until immediately after F makes its section 444 election for the taxable year beginning February 1, 1987. Thus, F is allowed to make a section 444 election for its taxable year beginning February 1, 1987. However, pursuant to paragraph (b)(3) of this section, F will have its section 444 election terminated for subsequent years unless the tax deferral inherent in the structure is eliminated (e.g., F1 is liquidated or the individual owners of F contribute their interests in F1 to F) prior to the date specified in paragraph (d) of this section for subsequent taxable years beginning on or after February 1, 1988.

*Example 18.* The facts are the same as in Example 16, except that F1 is 99 percent owned by F and none of the individual owners of F own any portion of F1. Furthermore, F obtained no tax benefit from creating and contributing assets to F1. Given these facts paragraph (b)(3) of this section does not apply and thus, F may make a section 444 election for its taxable year beginning February 1, 1987.

*Example 19.* G, a partnership with an October 31 taxable year, desires to retain its October 31 taxable year for its taxable year beginning November 1, 1987. However, as of December 31, 1987, G owns a 30 percent interest in G1, a calendar year partnership. G owns no other deferral entity, and G is 100 percent owned by calendar year individuals. Furthermore, G's interest in G1 does not meet the de minimis rule provided in paragraph (c)(3) of this section. Thus, in order to avoid being a tiered structure, G sells its interest in G1 to an unrelated third party prior to the date G timely makes its section 444 election for its taxable year beginning November 1, 1987. Although the sale of G1 allows G to qualify to make a section 444 election, and therefore to obtain a significant tax benefit, such benefit is not unintended. Thus, paragraph (b)(3) of

this section does not apply, and G may make a section 444 election for its taxable year beginning November 1, 1987.

(g) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19698, May 27, 1988, as amended by T.D. 8996, 67 FR 35012, May 17, 2002]

**§ 1.444-3T Manner and time of making section 444 election (temporary).**

(a) *In general.* A section 444 election shall be made in the manner and at the time provided in this section.

(b) *Manner and time of making election—(1) General rule.* A section 444 election shall be made by filing a properly prepared Form 8716, "Election to Have a Tax Year Other Than a Required Tax Year," with the Service Center indicated by the instructions to Form 8716. Except as provided in paragraphs (b) (2) and (4) of this section, Form 8716 must be filed by the earlier of—

(i) The 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective, or

(ii) The due date (without regard to extensions) of the income tax return resulting from the section 444 election.

In addition, a copy of Form 8716 must be attached to Form 1065 or Form 1120 series form, whichever is applicable, for the first taxable year for which the section 444 election is made. Form 8716 shall be signed by any person who is authorized to sign Form 1065 or Form 1120 series form, whichever is applicable. (See sections 6062 and 6063, relating to the signing of returns.) The provisions of this paragraph (b)(1) may be illustrated by the following examples.

*Example 1.* A, a partnership that began operations on September 10, 1988, is qualified to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 10, 1988. Pursuant to paragraph (b)(1) of this section, A must file Form 8716 by the earlier of the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective (*i.e.*, February 15, 1989) or the due date (without regard to extensions) of the partnership's tax return for the period September 10, 1988 to September 30, 1988 (*i.e.*, January 15, 1989). Thus, A must file Form 8716 by January 15, 1989.

*Example 2.* The facts are the same as in Example 1, except that A began operations on October 20, 1988. Based upon these facts, A must file Form 8716 by March 15, 1989, the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective.

*Example 3.* B is a corporation that first becomes a personal service corporation for its taxable year beginning September 1, 1988. B qualifies to make a section 444 election to use a September 30 taxable year for its taxable year beginning September 1, 1988. Pursuant to this paragraph (b)(1), B must file Form 8716 by December 15, 1988, the due date of the income tax return for the short period September 1 to September 30, 1988.

(2) *Special extension of time for making an election.* If, pursuant to paragraph (b)(1) of this section, the due date for filing Form 8716 is prior to July 26, 1988, such date is extended to July 26, 1988. The provisions of this paragraph (b)(2) may be illustrated by the following examples.

*Example 1.* B, a partnership that historically used a June 30 taxable year, is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. Absent paragraph (b)(2) of this section, B would be required to file Form 8716 by December 15, 1987. However, pursuant to paragraph (b)(2) of this section, B's due date for filing Form 8716 is extended to July 26, 1988.

*Example 2.* C, a partnership that began operations on January 20, 1988, is qualified to make a section 444 election to use a year ending September 30 for its taxable year beginning January 20, 1988. Absent paragraph (b)(2) of this section, C is required to file Form 8716 by June 15, 1988 (the 15th day of the fifth month following the month that includes the first day of the taxable year for which the election will first be effective). However, pursuant to paragraph (b)(2) of this section, the due date for filing Form 8716 is July 26, 1988.

(3) *Corporation electing to be an S corporation—(i) In general.* A corporation electing to be an S corporation is subject to the same time and manner rules for filing Form 8716 as any other taxpayer making a section 444 election. Thus, a corporation electing to be an S corporation that desires to make a section 444 election is not required to file Form 8716 with its Form 2553, "Election by a Small Business Corporation." However, a corporation electing to be an S corporation after September 26,

1988, is required to state on Form 2553 its intention to—

(A) Make a section 444 election, if qualified, or

(B) Make a “back-up section 444 election” as described in paragraph (b)(4) of this section.

If a corporation electing to be an S corporation fails to state either of the above intentions, the District Director may, at his discretion, disregard any section 444 election for such taxpayer.

(ii) *Examples.* The provisions of this paragraph (b)(3) may be illustrated by the following examples.

*Example 1.* D is a corporation that commences operations on October 1, 1988, and elects to be an S corporation for its taxable year beginning October 1, 1988. All of D’s shareholders use the calendar year as their taxable year. D desires to adopt a September 30 taxable year. D does not believe it has a business purpose for a September 30 taxable year and thus it must make a section 444 election to use such year. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 that, if qualified, it will make a section 444 election to adopt a year ending September 30 for its taxable year beginning October 1, 1988. If D is qualified (*i.e.*, D is not a member of a tiered structure on December 31, 1988) to make a section 444 election for its taxable year beginning October 1, 1988, D must file Form 8716 by March 15, 1989. If D ultimately is not qualified to make a section 444 election for its taxable year beginning October 1, 1988, D’s election to be an S corporation will not be effective unless, pursuant to the instructions to Form 2553, D made a back-up calendar year election (*i.e.*, an election to adopt the calendar year in the event D ultimately is not qualified to make a section 444 election for such year).

*Example 2.* The facts are the same as in Example 1, except that D believes it can establish, to the satisfaction of the Commissioner, a business purpose for adopting a September 30 taxable year. However, D desires to make a “back-up section 444 election” (see paragraph (b)(4) of this section) in the event that the Commissioner does not grant permission to adopt a September 30 taxable year based upon business purpose. Based on these facts, D must, pursuant to the instructions to Form 2553, state on Form 2553 its intention, if qualified, to make a back-up section 444 election to adopt a September 30 taxable year. If, by March 15, 1989, D has not received permission to adopt a September 30 taxable year and D is qualified to make a section 444 election, D must make a back-up election in accordance with paragraph (b)(4) of this section.

(4) *Back-up section 444 election—(i) General rule.* A taxpayer that has requested (or is planning to request) permission to use a particular taxable year based upon business purpose, may, if otherwise qualified, file a section 444 election (referred to as a “back-up section 444 election”). If the Commissioner subsequently denies the business purpose request, the taxpayer will, if otherwise qualified, be required to activate the back-up section 444 election. See examples (1) and (2) in paragraph (b)(4)(iv) of this section.

(ii) *Procedures for making a back-up section 444 election.* In addition to following the general rules provided in this section, a taxpayer making a back-up section 444 election should, in order to allow the Service to process the affected returns in an efficient manner, type or legibly print the words “BACK-UP ELECTION” at the top of Form 8716, “Election to Have a Tax Year Other Than a Required Tax Year.” However, if such Form 8716 is filed on or after the date a Form 1128, Application for Change in Accounting Period, is filed with respect to a period that begins on the same date, the words “FORM 1128 BACK-UP ELECTION” should be typed or legibly printed at the top of Form 8716.

(iii) *Procedures for activating a back-up section 444 election—(A) Partnerships and S corporations—(1) In general.* A back-up section 444 election made by a partnership or S corporation is activated by filing the return required in § 1.7519-2T (a)(2)(i) and making the payment required in § 1.7519-1T. The due date for filing such return and payment will be the later of—

(i) The due dates provided in § 1.7519-2T, or

(ii) 60 days from the date the Commissioner denies the business purpose request.

However, interest will be assessed (at the rate provided in section 6621 (a)(2)) on any required payment made after the due date (without regard to any extension for a back-up election) provided in § 1.7519-2T (a)(4)(i) or (a)(4)(ii), whichever is applicable, for such payment. Interest will be calculated from such due date to the date such amount is actually paid. Interest assessed under this paragraph will be separate

from any required payments. Thus, interest will not be subject to refund under § 1.7519-2T.

(2) *Special rule if Form 720 used to satisfy return requirement.* If, pursuant to § 1.7519-2T (a)(3), a partnership or S corporation must use Form 720, "Quarterly Federal Excise Tax Return," to satisfy the return requirement of § 1.7519-2T (a)(2), then in addition to following the general rules provided in § 1.7519-2T, the partnership or S corporation must type or legibly print the words "ACTIVATING BACK-UP ELECTION" on the top of Form 720. A partnership or S corporation that would otherwise file a Form 720 on or before the date specified in paragraph (b)(4)(iii)(A)(I) of this section may satisfy the return requirement by including the necessary information on such Form 720. Alternatively, such partnership or S corporation may file an additional Form 720 (*i.e.*, a Form 720 separate from the Form 720 it would otherwise file). Thus, for example, if the due date for activating an S corporation's back-up election is November 15, 1988, and the S corporation must file a Form 720 by October 31, 1988, to report manufacturers excise tax for the third quarter of 1988, the S corporation may use that Form 720 to activate its back-up election. Alternatively, the S corporation may file its regular Form 720 that is due October 31, 1988, and file an additional Form 720 by November 15, 1988, activating its back-up election.

(B) *Personal service corporations.* A back-up section 444 election made by a personal service corporation is activated by filing Form 8716 with the personal service corporation's original or amended income tax return for the taxable year in which the election is first effective, and typing or legibly printing the words—"ACTIVATING BACK-UP ELECTION" on the top of such income tax return.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples. Also see Example 2 in paragraph (b)(3) of this section.

*Example 1.* E, a partnership that historically used a June 30 taxable year, requested (pursuant to section 6 of Rev. Proc. 87-32, 1987-28 I.R.B. 14) permission from the Commissioner to retain a June 30 taxable year for its taxable year beginning July 1, 1987.

Furthermore, E is qualified to make a section 444 election to retain a June 30 taxable year for its taxable year beginning July 1, 1987. However, as of the date specified in paragraph (b)(2) of this section, the Commissioner has not determined whether E has a valid business purpose for retaining its June 30 taxable year. Based on these facts, E may, by the date specified in paragraph (b)(2) of this section, make a back-up section 444 election to retain its June 30 taxable year.

*Example 2.* The facts are the same as in Example 1. In addition, on August 12, 1988, the Internal Revenue Service notifies E that its business purpose request is denied. E asks for reconsideration of the Service's decision, and the Service sustains the original denial on September 30, 1988. Based on these facts, E must activate its back-up section 444 election within 60 days after September 30, 1988.

*Example 3.* The facts are the same as in Example 1, except that E desires to make a section 444 election to use a year ending September 30 for its taxable year beginning July 1, 1987. Although E qualifies to make a section 444 election to retain its June 30 taxable year, E may make a back-up section 444 election for a September 30 taxable year.

(c) *Administrative relief—(1) Extension of time to file income tax returns—(i) Automatic extension.* If a partnership, S corporation, or personal service corporation makes a section 444 election (or does not make a section 444 election, either because it is ineligible or because it decides not to make the election, and therefore changes to its required taxable year) for its first taxable year beginning after December 31, 1986, the due date for filing its income tax return for such year shall be the later of—

- (A) The due date established under—
  - (1) Section 6072, in the case of Form 1065,
  - (2) § 1.6037-1 (b), in the case of Form 1120S,
  - (3) Section 6072 (b), in the case of other Form 1120 series form; or
- (B) August 15, 1988.

The words "SECTION 444 RETURN" should, in order to allow the Service to process the affected returns in an efficient manner, be typed or legibly printed at the top of the Form 1065 or Form 1120 series form, whichever is applicable, filed under this paragraph (c)(1)(i).

(ii) *Additional extensions.* If the due date of the income tax return for the first taxable year beginning after December 31, 1986, extended as provided in paragraph (c)(1)(i)(B) of this section,

occurs before the date that is 6 months after the date specified in paragraph (c)(1)(i)(A) of this section, the partnership, S corporation, or personal service corporation may request an additional extension or extensions of time (up to 6 months after the date specified in paragraph (c)(1)(i)(A) of this section) to file its income tax return for such first taxable year. The request must be made by the later of the date specified in paragraph (c)(1)(i)(A) or (c)(1)(i)(B) of this section and must be made on Form 7004, "Application for Automatic Extension of Time To File Corporation Income Tax Return", or Form 2758, "Application for Extension of Time to File U.S. Partnership, Fiduciary, and Certain Other Returns," whichever is applicable, in accordance with the form and its instructions. In addition, the following words should be typed or legibly printed at the top of the form—"SECTION 444 REQUEST FOR ADDITIONAL EXTENSION."

(iii) *Examples.* The provisions of paragraph (c)(1) of this section may be illustrated by the following examples.

*Example 1.* G, a partnership that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. Absent paragraph (c)(1)(i) of this section, G's Form 1065 for the taxable year ending January 31, 1988, is due on or before May 15, 1988. However, if G types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

*Example 2.* The facts are the same as in Example 1, except that G desires to extend the due date of its income tax return for the year ending January 31, 1988, to a date beyond August 15, 1988. Pursuant to paragraph (c)(1)(ii) of this section, G may extend such return to November 15, 1988 (*i.e.*, the date that is up to 6 months after May 15, 1988, the normal due date of the return). However, in order to obtain this additional extension, G must file Form 2758 pursuant to paragraph (c)(1)(i) of this section on or before August 15, 1988.

*Example 3.* H, a partnership that historically used a May 31 taxable year, makes a section 444 election to use a year ending September 30 for its taxable year beginning on June 1, 1987. Absent paragraph (c)(1)(i) of this section, H's Form 1065 for the taxable year beginning June 1, 1987, and ending September 30, 1987, is due on or before January 15, 1988. However, if H types or legibly prints "SECTION 444 RETURN" at the top of Form 1065

for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988.

*Example 4.* The facts are the same as in Example 3, except H desires to further extend (*i.e.*, extend beyond August 15, 1988) the due date of its income tax return for its taxable year beginning June 1, 1987, and ending September 30, 1987. Since August 15, 1988, is 6 months or more after the due date (without extensions) of such return, paragraph (c)(1)(ii) of this section prevents H from further extending the time for filing such return.

*Example 5.* I, a partnership that historically used a June 30 taxable year, considered making a section 444 election to retain such taxable year, but eventually decided to change to a December 31, taxable year (I's required taxable year). Absent paragraph (c)(1)(i) of this section, I's Form 1065 for the taxable year beginning July 1, 1987, and ending December 31, 1987, is due on or before April 15, 1988. Pursuant to paragraph (c)(1)(i) of this section, if I types or legibly prints "SECTION 444 RETURN" at the top of Form 1065 for such year, paragraph (c)(1)(i) of this section automatically extends the due date of such return to August 15, 1988. In addition, I may further extend such return pursuant to paragraph (c)(1)(ii) of this section.

(2) *No penalty for certain late payments—(i) In general.* In the case of a personal service corporation or S corporation described in paragraph (c)(1)(i) of this section, no penalty under section 6651 (a)(2) will be imposed for failure to pay income tax (if any) for the first taxable year beginning after December 31, 1986, but only for the period beginning with the last date for payment and ending with the later of the date specified in paragraph (c)(1)(i) or paragraph (c)(1)(ii) of this section.

(ii) *Example.* The provisions of paragraph (c)(2)(i) of this section may be illustrated by the following example.

*Example.* J, a personal service corporation that historically used a January 31 taxable year, makes a section 444 election to retain such year for its taxable year beginning February 1, 1987. The last date (without extension) for payment of J's income tax (if any) for its taxable year beginning February 1, 1987, is April 15, 1988. However, under paragraph (c)(2)(i) of this section, no penalty under section 6651(a)(2) will be imposed on any underpayment of income tax for the period beginning April 15, 1988 and ending August 15, 1988.

(d) *Effective date.* This section is effective for taxable years beginning after December 31, 1986.

[T.D. 8205, 53 FR 19703, May 27, 1988]

**§ 1.444-4 Tiered structure.**

(a) *Electing small business trusts.* For purposes of § 1.444-2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is treated as an electing small business trust under section 1361(e). An S corporation with an electing small business trust as a shareholder may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however, taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1996.

(b) *Certain tax-exempt trusts.* For purposes of § 1.444-2T, solely with respect to an S corporation shareholder, the term *deferral entity* does not include a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a). An S corporation with a trust as a shareholder that is described in section 401(a) or section 501(c)(3), and is exempt from taxation under section 501(a) may make an election under section 444. This paragraph is applicable to taxable years beginning on and after December 29, 2000; however taxpayers may voluntarily apply it to taxable years of S corporations beginning after December 31, 1997.

(c) *Certain terminations disregarded—*  
(1) *In general.* An S corporation that is described in this paragraph (c)(1) may request that a termination of its election under section 444 be disregarded, and that the S corporation be permitted to resume use of the year it previously elected under section 444, by following the procedures of paragraph (c)(2) of this section. An S corporation is described in this paragraph if the S corporation is otherwise qualified to make a section 444 election, and its previous election was terminated under § 1.444-2T(a) solely because—

(i) In the case of a taxable year beginning after December 31, 1996, a trust that is treated as an electing small business trust became a shareholder of such S corporation; or

(ii) In the case of a taxable year beginning after December 31, 1997, a trust that is described in section 401(a) or 501(c)(3), and is exempt from taxation under section 501(a) became a shareholder of such S corporation.

(2) *Procedure—*(i) *In general.* An S corporation described in paragraph (c)(1) of this section that wishes to make the request described in paragraph (c)(1) of this section must do so by filing Form 8716, “Election To Have a Tax Year Other Than a Required Tax Year,” and typing or printing legibly at the top of such form—“CONTINUATION OF SECTION 444 ELECTION UNDER § 1.444-4.” In order to assist the Internal Revenue Service in updating the S corporation’s account, on Line 5 the Box “Changing to” should be checked. Additionally, the election month indicated must be the last month of the S corporation’s previously elected section 444 election year, and the effective year indicated must end in 2002.

(ii) *Time and place for filing Form 8716.* Such form must be filed on or before October 15, 2002, with the service center where the S corporation’s returns of tax (Forms 1120S) are filed. In addition, a copy of the Form 8716 should be attached to the S corporation’s short period Federal income tax return for the first election year beginning on or after January 1, 2002.

(3) *Effect of request—*(i) *Taxable years beginning on or after January 1, 2002.* An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will be permitted to resume use of the year it previously elected under section 444, commencing with its first taxable year beginning on or after January 1, 2002. Such S corporation will be required to file a return under § 1.7519-2T for each taxable year beginning on or after January 1, 2002. No payment under section 7519 will be due with respect to the first taxable year beginning on or after January 1, 2002. However, a required payment will be due on or before May 15, 2003, with respect to such S corporation’s second continued section 444 election year that begins in calendar year 2002.

(ii) *Taxable years beginning prior to January 1, 2002.* An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under § 1.7519-2T, with respect to taxable years beginning on or after the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) *Section 7519: required payments and returns.* The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its federal income tax returns on the basis of its required taxable year.

[T.D. 8994, 67 FR 34394, May 14, 2002]

#### METHODS OF ACCOUNTING

##### METHODS OF ACCOUNTING IN GENERAL

#### § 1.446-1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term “method of accounting” includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or re-

quired by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer’s regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw